The Concern about Negative Rates

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Today about one-third of the developed bond market actually has a negative yield to it. We need to define what that means: it's not that the coupons are actually negative, it's that the price of the securities is so high that even if you adjust for every expected coupon payment and the return of principal at maturity, your return is negative. This is something that's really unprecedented in the 5,000 years or so of financial history that we have. We've never seen negative rates until today.

Now, negative rates work in theory, but not in practice. I think there's a key difference between having a lower rate—so, cutting rates from 3% to 2%, from 2% to 1%—and actually cutting rates below zero.

Negative rates have a cost that really doesn't get a lot of press, but I think it's starting to. If you are saving for retirement, if you run a bank or a financial intermediary, if you are a pension plan, negative rates make your job very, very difficult.

What we've seen is that throughout Europe—where rates have been negative—European financials today are trading at about the same price that they were 30 years ago. It's a very similar story in Japan.

So, you have negative rates—it's not because you have negative coupons, it's because the price of the securities is very, very high, and those negative rates really are creating problems throughout the capital market.

Interest rates are what we use to price other risk instruments, so think about options, think about stocks. In theory, if rates are going to be negative forever, stocks should be much, much higher. The models will tell you they're infinite, but we know that's not true or realistic.

Negative rates are a huge rarity in financial history, and the costs and the unforeseen ramifications of having those rates are just starting to appear.

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Fixed income securities entail interest rate risk. High yield securities are also subject to increased credit risk and liquidity risk.

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