Negative Yield Bonds

Why in News

Recently, demand for **negative yield bonds** is on rise in the global market.

Key Points

- **Negative Yield Bonds:** Are **debt instruments** that offer to pay the investor a maturity amount **lower than the purchase** price of the bond. These are generally **issued** by **central banks or governments,** and **investors pay interest to the borrower** to keep their money with them.
    - **Bond:** Is an **instrument** to **borrow money.** A bond could be **floated/issued** by a country’s **government** or by a **company** to raise funds.
    - **Yield:** The yield of a bond is the **effective rate of return** that it earns. But the rate of return is **not fixed;** it changes with the price of the bond.
        - Generally, investors purchase the bonds at their **face value,** which is the principal amount invested. In return, **investors typically earn a yield** of a bond.
        - Each bond has a **maturity date,** which is when the investor gets paid back the **principal amount.**
- **Reasons behind buying Negative Yield Bonds:**
    - **To create a diverse portfolio:** Many hedge funds and **investment firms** that manage mutual funds invest in negative bonds in order to diversify their investment.
    - **To use them as collateral:** Bonds are often used to pledge as **collateral** for financing and as a result, need to be held regardless of their price or yield.
    - **To take Benefit from Currency Gain:** Foreign investors might believe the currency's exchange rate will rise, which would offset the negative bond yield.
    - **To Avoid Domestic Deflation Risk:** Domestically, investors might expect a period of deflation, or lower prices in the economy.
        - **For Example:** Consider a one-year bond that yields minus 5% but at the same time inflation is expected to be minus 10% over the same period.
            - That means the investor in the bond would have more purchasing power at the end of the year because prices for goods and services would have declined far more than would the value of the investment in the fixed-income security.
    - **To Create Safe Haven Assets:** Investors might also be interested in negative bond yields if the loss is less than it would be with another investment. In times of **economic uncertainty,** many investors rush to buy bonds because they're considered **safe-haven investments.**
        - These purchases are called the **flight-to-safety-trade** in the bond market. During such a time, investors might accept a negative-yielding bond because the negative yield might be far less of a loss than a potential double-digit percentage loss in the equity markets.

- **Current Scenario:**
    - Today when the world is fighting the **Covid-19 pandemic** and **interest rates** related to bonds and other financial instruments in developed markets across Europe are much lower, investors are looking for relatively better-yielding debt instruments **to safeguard their interests.**
    - **China** sold its negative-yield bonds for the first time, and this saw a high demand from investors across **Europe.**
    - **Reason for High Demand:**
        - **Low risk with Chinese Bonds :** Yields offered in safe European bonds are much lower than ones offered by China.
            - As against minus —0.15% yield on the 5-year bond issued by China, the yields offered in safe European bonds are much lower, between –0.5% and —0.75%.
        - **China's positive** Gross Domestic Product (GDP): Majority of the large economies are facing a contraction in their GDP for 2020-21 while China is one country that is set to witness positive growth as its GDP expanded by 4.9% in the third quarter of 2020.
        - **Increase in Covid-19 cases:** While Europe, the United States and other parts of the world are facing a second wave of **Covid-19 cases,** China has demonstrated that it has controlled the spread of the pandemic and is therefore seen as a more **stable region.**
    - **Factor Driving the High Demand:**
        - **Availability of money:** Huge amount of **liquidity** injected by the **global central banks** after the pandemic.
            - They have injected an estimated more than **10 trillion dollars** of liquidity through various instruments in the financial system.
        - **Avoiding risk:** Investors might also be temporarily parking money in negative yield bonds for the purpose of hedging their risk portfolio in equities. To gain profit and avoid losses in case the fresh wave of the **Covid-19 pandemic** leads to further lockdowns of economies.

Source:IE