PORTFOLIO INSIGHTS

Alternative investment strategies

Lending, borrowing and investing in a negative rate world

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IN BRIEF

- The reality—or the specter—of ultra-low or negative interest rates, and the journey to them, involves broad impacts on asset classes, particularly alternatives.
- Ultra-low or negative rates should continue prompting some borrowers and lenders in the alternatives space to take on more risk; in real estate, where supply is strained, we anticipate property bubbles. Responsible investors will avoid the frenzy.
- In private equity investing, ultra-low or negative rates combined with strong secondary market demand could have unintended consequences.
- Europe and Japan's experiences suggest an adverse aggregate impact on lenders. U.S. banks are actively studying these other regions' experiences to prepare for the possibility that negative rates will come to the U.S. (which is not our base case).
- The reality and the specter of an ultra-low or negative interest rate environment make risk management and good portfolio manager selection increasingly important.

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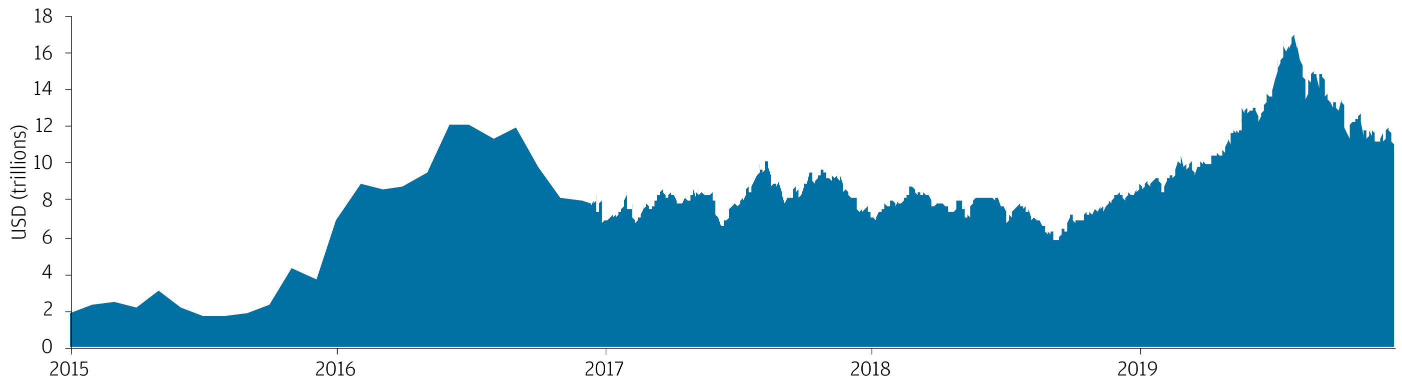
ONE PURPOSE OF QUANTITATIVE EASING (QE) IS TO MAKE HOLDING HIGH-QUALITY BONDS SO UNATTRACTIVE THAT INVESTORS ARE FORCED TO EMBRACE RISKIER INVESTMENTS. While the full economic impact of QE is unclear, the asset purchase programs implemented since the financial crisis have successfully induced investors to take on more risk. However, because underlying economies did not respond in the way that central bankers hoped (inflation and growth are still stubbornly low), yet another unconventional policy tool has come into play: negative interest rates. Here, we examine how ultra-low and negative rates have boosted demand for private market assets, and how negative rates affect borrowers, lenders and market volatility.

Today, there is approximately USD13 trillion of negative yielding debt around the world, as negative rates have broadened out beyond the sphere of short-term policy rates where they were first implemented (**EXHIBIT 1**). The majority of negative yielding debt is government-issued, but we are increasingly seeing corporate bonds with negative yields and even consumer debt (a Danish bank issued mortgages with a negative interest rate at the end of the summer). Surprisingly, negative yields do not seem to have deterred investors from continuing to pour money into fixed income. This reflects regulatory constraints as well as uncertainty around the outlook for global growth and geopolitical stability, the lackluster demographic environment and a continued preference for saving over investment.

Most of the recent surge in negative yielding debt is government-issued but corporate issuance is rising

EXHIBIT 1: NEGATIVE YIELDING DEBT



Source: Bloomberg Barclays, FactSet, J.P. Morgan Asset Management; data as of January 14, 2020.

HOW TO INVEST WHEN MONEY IS FREE

While the savings/investment imbalance looks set to persist, and demand for high-quality fixed income along with it, the combination of negative rates and QE has successfully pushed some investors further out the risk spectrum. At first, this entailed owning public equities and fixed income, but in the past few years, ultra-low and negative rates have fostered demand for private market assets. From a demand perspective, this makes sense—to generate their required rates of return, investors need more than the muted returns than they are likely to find in public markets, at least over the near or medium term. And as long as negative interest rates persist, this demand is unlikely to wane.

In the long run, the combination of strong demand for private investments and negative interest rates will have significant consequences. Lenders and borrowers will be impacted in different ways, and some risks are likely to evolve. Given that most alternative investments actively utilize leverage at some point in their lifecycle, it makes sense to try to distill the impact of negative rates on borrowers and lenders separately. We also consider the implications of negative rates for volatility, since volatility indirectly impacts the performance of many alternative investments. Perhaps the rabbit hole that many associate with negative rates is deeper than anyone originally thought.

TO BORROW, OR NOT TO BORROW?

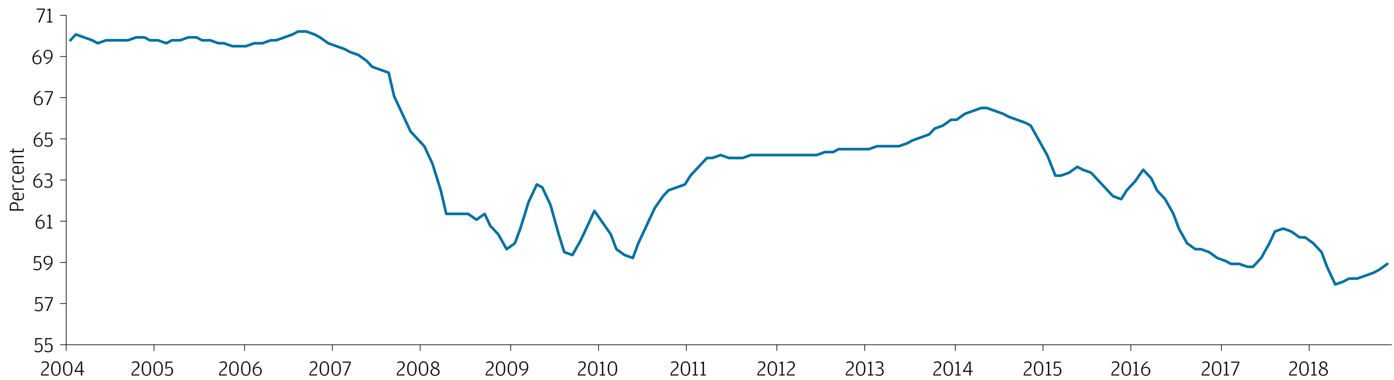
For borrowers, the biggest risk seems to be that negative rates incentivize the use of leverage in such a way that it undermines future returns. However, some investors we have spoken with highlight that cheap financing costs will not encourage them to take on more risk; rather, they have been looking to refinance wherever possible. This seems to be the more prudent approach, but it would be naïve to think that this is how the herd will behave; investors who do take advantage of cheap borrowing costs in an effort to boost returns may later regret the decision.

The use of leverage may be particularly relevant in the real estate sector. In supply-constrained locations, negative rates may encourage property bubbles fueled by rising leverage, while opportunistic and value-add funds apply more leverage to core properties in order to hit return targets. At the same time, core managers may move into the value-add and opportunistic space where credit quality, rather than base rates, tends to drive borrowing costs.

As a result, we believe investors should focus on the loan-to-value (LTV) metric as the primary measure of risk; it conveys the amount of financial risk, rather than operating risk, that a potential investment entails. As **EXHIBIT 2** shows, the average commercial real estate LTV is well below pre-financial crisis levels, suggesting that borrowers and lenders remain cautious. However, a sustained period of ultra-low or negative rates may very well cause this trend to reverse.

Commercial real estate LTV is at lower levels than before the global financial crisis

EXHIBIT 2: AVERAGE COMMERCIAL REAL ESTATE LTV, TRAILING 12-MONTH AVERAGE



Source: RCA, J.P. Morgan Asset Management; data as of October 31, 2019.

In private equity and credit, it seems reasonable to expect the same problem of price appreciation as more and more leverage is used to purchase assets. Furthermore, negative interest rates and solid demand in the secondary market could lead to the continued proliferation of zombie companies, which may account for 12% of developed market corporations.[1] As troubled companies find themselves able to roll over debt and avoid bankruptcy, their survival reduces the supply of distressed securities, making bespoke opportunities more attractive until the credit cycle turns.

KEEP ON LENDIN'

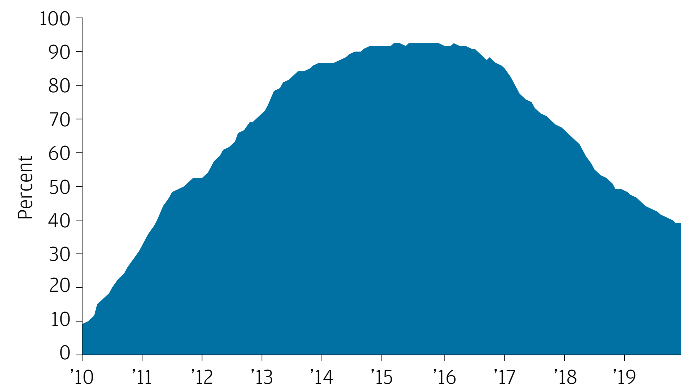
While ultra-low or negative rates will likely have a mixed impact on borrowers—and outcomes will depend on how responsibly leverage is used—one would think that the aggregate impact on lenders would be negative. Based on the experiences of lenders in Europe and Japan, this is a reasonable conclusion to draw. Indeed, U.S. banks are actively studying how to deal with negative rates. Banks are currently focusing on repricing customer deposits quickly, switching to fees where possible and, above all else, preserving the spread on lending products.

What about the impact on nonbank entities? In a space that has grown significantly since the financial crisis, lenders are finding it increasingly difficult to preserve returns. Most loans are made using a base rate, like LIBOR (London Inter-bank Offered Rate), and then a spread to account for credit risk.

In the immediate aftermath of the financial crisis, lenders put interest rate floors in place to limit the amount that rates could fall, but 10-plus years out from the financial crisis, lenders have loosened their restraint in a somewhat worrying fashion and the number of loans with floors has fallen (**EXHIBIT 3**). While the number of loans with floors could begin to rise in a sustained period of ultra-low or negative rates, the growth in lenders and assets under management may make this a greater challenge than it has been in the past. As such, investors will be required to focus on underwriting standards and loan structure to preserve the income that lending strategies are able to generate in a negative rate environment.

Rise in nonbank lenders is one reason behind a worrying trend: Fewer loans have a LIBOR floor

EXHIBIT 3: % OF J.P. MORGAN LEVERAGED LOAN INDEX

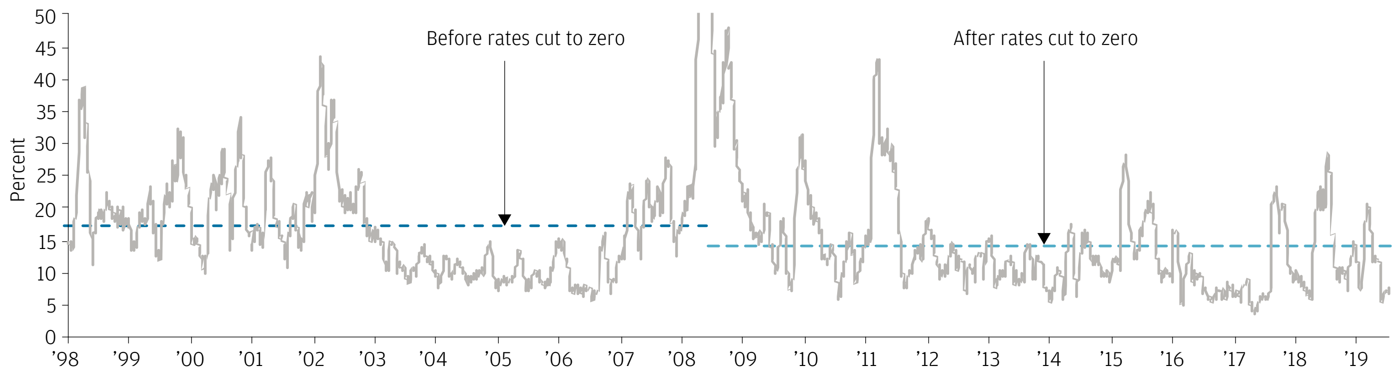


Source: J.P. Morgan Credit Research, J.P. Morgan Asset Management; data as of December 31, 2019.

[1] Ryan Banerjee and Boris Hofmann, "The rise of zombie firms: Causes and consequences," *BIS Quarterly Review* (September 2018), https://www.bis.org/publ/qtrpdf/r_qt1809g.pdf.

Equity market volatility fell 3% in the decade after the Federal Reserve cut rates to zero, suggesting monetary easing may dampen market volatility

EXHIBIT 4: S&P 500 REALIZED VOLATILITY—ROLLING 30-DAY STANDARD DEVIATION OF DAILY RETURNS



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management; data as of January 14, 2020.

In the case of direct corporate lending, where there is no use of leverage, we see in the regions where ultra-low or negative rates prevail only a marginally adverse impact, and we think that would also be the case if they spread to other regions. But yields have and would move lower, as there is usually not enough spread widening to offset the entire decline in the base rate. On the other hand, lenders that rely on securitization, term finance or other forms of leverage may be in a better position. This lending tends to be riskier because it involves the creation of an asset and then lending against that asset. However, because yields in this space tend to be stickier, lower base rates mean the spread between an asset's yield and the funding cost should widen, enhancing the excess return available to investors.

VOLATILITY: JEKYLL AND HYDE

While the implications of negative rates for borrowers and lenders are fairly straightforward—some participants will take on more risk, but responsible investors will avoid the frenzy—the impact on volatility is a bit more complicated. To start, it is important to recognize that price volatility in a vacuum is neither good nor bad; it is direction-agnostic. As such, we believe that the impact of negative rates on volatility will depend on the underlying driver of negative rates.

The past decade has shown us that ultra-low and negative rates due to easier monetary policy tend to dampen both macroeconomic and capital market volatility. Volatility has been over 3 percentage points lower since the Federal Reserve cut rates to zero on December 16, 2008 than it had been during the prior decade (**EXHIBIT 4**). This suggests that volatility should be lower if negative rates are accompanied by easier monetary policy.

We can also envision a scenario in which negative interest rates lead to an increase in volatility. Volatility would likely remain muted as rates fell and central banks became increasingly accommodative, but central bankers might eventually be forced to pause their easing campaigns once reaching the reversal rate.[2] In this environment, asset prices would be increasingly sensitive to any change in macroeconomic conditions, particularly given the idea that ultra-low or negative rates encourage financial asset creation at a faster pace than output growth.[3] This suggests that changes in macroeconomic conditions would lead to higher volatility than if nominal rates were above zero. So while the journey to a negative rate world should be calm, investing in it has the potential to be quite volatile.

But why would volatility move higher in a sustained ultra-low or negative interest rate environment? First, a broad increase in the price of assets would make them more susceptible to sharp drawdowns during periods of stress or uncertainty, and wider equity risk premiums could actually tighten financial conditions. Second, equity prices would be increasingly volatile as their sensitivity to discount rates—which are closely linked to base rates—rose when discount rates were at very low levels.

[2] A reversal rate in monetary policy is the rate at which accommodative monetary policy "reverses" its effect and becomes contractionary. Ampudia, Miguel, and Skander J. Van den Heuvel, "Monetary Policy and Bank Equity Values in a Time of Low and Negative Interest Rates," *Finance and Economics Discussion Series* 2019-064, The Federal Reserve Board (2019).

[3] Financial asset creation and price gains have outpaced global economic growth.

Finally, fixed income would likely see wider spreads, as credit risk would need to be incorporated if base rates were to hit their floor or go negative. Historically, wider spreads have been positively correlated with volatility. Furthermore, when fixed income lacks income, it starts to trade more like a commodity, as duration is the only factor that really matters for returns.

INVESTMENT IMPLICATIONS

It is unclear what a world of negative interest rates will mean for the price and behavior of assets. Certainly Europe and Japan's experiences have demonstrated that the impact on the banking sector can be quite significant. It is not our base case scenario that negative rates come to the U.S., but if they do, traditional financial institutions have a draft playbook for how to respond.

What do negative rates mean for investments and portfolios? In the lending space, ultra-low or negative rates may potentially be offset by wider spreads, but there are risks from new entrants, increasing competition and the availability of leverage in new parts of the market. For fixed income more broadly, uncorrelated assets and bespoke lending opportunities that can generate a positive return without rates having to fall further seem well positioned, as do relative value strategies that are more agnostic to the level of rates.

In infrastructure investing, a focus on regulated and contracted assets can help mitigate interest rate risk. Furthermore, investors should focus on unlevered returns and LTV as measures of risk, and reset expectations on loans that are tied to inflation, which we expect would see more muted growth due to the subdued inflation and/or inflation expectations that would likely accompany negative rates.

In equities, a focus on quality businesses with transparent and forecastable cash flows seems prudent. In private equity, small and mid-market companies represent the greatest opportunity, as returns can be driven by operational improvement rather than financial engineering.

A negative interest rate environment will make risk and portfolio management increasingly important and prudent manager selection will continue to differentiate winners from losers. Escaping from this environment will involve coordination between monetary and fiscal policy, something we expect. With that will come a completely different set of considerations. Investors should remain flexible in their allocations during the coming years so they can adapt to an ever-changing landscape—while negative rates are creating a limited number of concerns today, it would be foolish to expect that the current environment will not lead to imbalances and problems at some point down the road.

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