SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

When Negative Is Positive

Recent estimates are that a record $12.5 trillion of global debt carry negative yields. For bond markets in countries such as Germany, Japan and Switzerland, yields now are negative for all maturities as far out as 10 years. Investment in a bond with a negative yield seems nonsensical. *"Invest your money now and be assured of getting less back later."* Some of the current environment reflects central banks setting short-term policy rates near zero to stimulate economic activity. Nevertheless, negative bond yields result from the confluence of investors willing to make transactions at such levels. Bond investing principles and the role of price inflation can provide perspective and investment implications.

PERSPECTIVE

Current bond yields by maturity among some key markets are shown in Chart I. While not the only market with a preponderance of positive bond yields, U.S. levels are notably higher than those in most other developed economy markets.

One year ago, the consensus forecast was that 10-year bond yields would be higher today. The implication of this forecast was that total returns (income plus price change) for the year just ended would be negative. In fact, yields declined to negative levels for three of the four countries shown in Chart II. Total returns were positive, consistent with a bond investing principle: bond prices rise if rates fall, no matter the level of rates. If yields were to fall further from here over the next year, bond total returns would be positive once again so long as price appreciation was greater than any negative yield. Also illustrated over the past year was the impact on bond markets from unanticipated changes in something as fundamental as central bank policy.

Price inflation has been the prevailing economic and financial paradigm throughout time. Inflation's effect is that the "real" (after inflation) future value of an asset is less than today's value. For example, a 2% annual inflation rate over 10 years reduces today's $1,000 bond to a real value of only $820 when repaid at maturity. Interest payments are affected as well along the way. Deflation, or falling price levels, has the opposite effect. Declining prices at an annual rate of -2% over 10 years increases the real value of today's $1,000 bond to $1,224. To gain over its life from a bond purchased with a negative yield today is to have an expectation of price deflation over time. Table I shows inflation and deflation impacts at maturity on 10-year bonds implied by current global yields.

INVESTMENT IMPLICATIONS

The emergence of negative yields seems at first glance to call bond investing principles into question. But bond price and yield relationships prevail even when the latter turns negative. When the impact of price inflation or deflation is considered, even investing at negative yields could prove beneficial. However, the expectation of price deflation over an extended period of time is at odds with historical outcomes. Bond investing can benefit from an accurate forecast of future yields. As Chart II illustrates, forecasting bond yields can be challenging. Bonds can play an important, diversifying role in a portfolio, but investing principles must be understood and the uncertainty of future yield trends must be considered.

CHART I

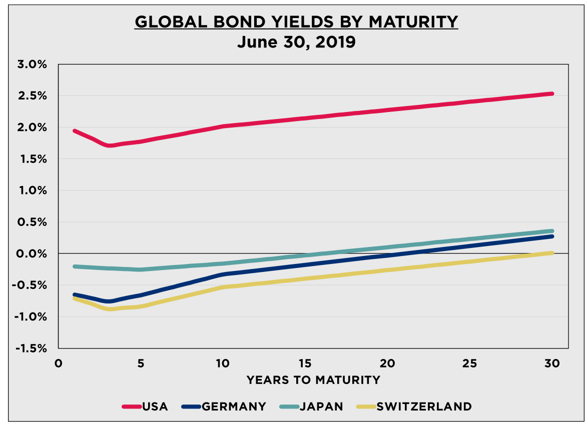
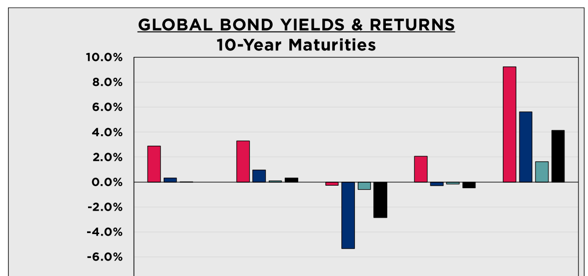


CHART II



	ACTUAL YIELD AS OF 6/30/18	ONE-YEAR AHEAD YIELD FORECAST	IMPLIED ONE-YEAR RETURN	ACTUAL YIELD AS OF 6/30/19	ACTUAL ONE-YEAR RETURN
USA	2.88%	3.28%	-0.26%	2.07%	9.23%
GERMANY	0.32%	0.96%	-5.33%	-0.28%	5.62%
JAPAN	0.01%	0.08%	-0.62%	-0.17%	1.63%
SWITZERLAND	0.00%	0.32%	-2.88%	-0.46%	4.13%

TABLE I

GLOBAL BOND YIELDS & REAL RETURNS
10-Year Maturities

	ACTUAL YIELDS AS OF 6/30/2019	IMPLIED REAL PRINCIPAL VALUE AS OF 6/30/2029
USA	2.07%	$815
GERMANY	-0.28%	$1,028
JAPAN	-0.17%	$1,017
SWITZERLAND	-0.46%	$1,047