Japanese bond rate goes negative as bank shares tumble

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The yield on 10-year Japanese government bonds has turned negative for the first time in history, amid growing concerns that ongoing turbulence in financial markets is broadening, with significant consequences for global banks.

Japan has become the first major economy with a sub-zero borrowing rate on its 10-year debt, as negative rates spread across the world. It is now estimated that some $7 trillion worth of government bonds globally are in negative territory. This means that if investors purchased them at current prices, and held them to maturity, they would make a loss.

The rush to buy government bonds—which pushes up their prices and lowers their yield, since they have an inverse relationship—is a symptom and indicator of investor concerns about the financial system and fears of global recession. As Japanese yields fell below zero, the yield on US 10-year treasury bonds continued to remain well below the 2 percent mark, regarded as a sign of recession.

Yields on long-term bonds have been falling faster than those on 2-year bonds, in a flattening of the so-called yield curve, also regarded as a sign of recession. The difference between the two yields is at its lowest level in almost nine years.

The plunge in the Japanese bond yield follows the decision last month by the Bank of Japan (BoJ) to move interest rates on new money held in deposits into negative territory, as well as statements by central bank governor Haruhiko Kuroda that further moves in that direction would be made if considered necessary.

Minutes from the meeting of the BoJ's governing board, which endorsed the decision in a 5-4 vote, revealed concern by board members that it would set off a move to lower interest rates around the world.

"Looking ahead, I am concerned that financial markets would expect further cuts in the interest rate into negative territory, leading to confusion and anxiety among financial institutions and depositors," one board member wrote.

That appears to be what has taken place, with bank stocks taking a major hit internationally. The key problem for the banks is that their business models rest, in part, on their ability to make profits from the differential between the rate at which they borrow and the rate they are able to charge. Lower rates narrow that margin.

As a consequence, bank stocks have been hammered in the global share market sell-off that began the New Year. The shares of Bank of America and Morgan Stanley, two of the biggest losers, are down 27 and 28 percent respectively.

The Fed's decision to lift interest rates in December was regarded as the start of a move, albeit at a very gradual pace, to return to a more normal interest rate regime that would help lift bank profits. That is because it would widen the spread between the rate at which they borrow and the yield on their loans.

However, a further rate rise in March is now widely regarded as being off the table and there are also doubts about whether the Fed will lift rates any further this year.

Consequently, all eyes in financial markets will be on Fed chairwoman Janet Yellen when she delivers semi-annual testimony to the House of Representatives and Senate today and tomorrow. The widespread sentiment is that if Yellen simply says that the Fed will examine rates on a meeting-by-meeting basis, it will only add to the confusion.

The largest German bank, Deutsche Bank, is in the eye of the mounting global banking and financial storm. Fears about its stability and its capacity to

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honour commitments to investors, who hold the relatively risky class of bonds it has issued, coupled with long-running worries over the adequacy of its capital base, have sent its shares plummeting.

Shares in the bank fell by 4.7 percent yesterday and are now down by 46 percent since the start of the year. Over the past six months, they have fallen 58 percent. For 2015, the bank reported a loss of €6.8 billion. Shares in the Swiss bank Credit Suisse have also been falling rapidly, dropping by 7.7 percent on Tuesday.

Deutsche Bank chief executive John Cryan issued a statement to staff that they should tell clients the bank remained “absolutely rock solid,” given its strong capital and risk position, and that it would pay coupons to holders of its riskier bonds, which had been “the subject of recent market concern.”

This was followed by an unusual step on the part of German finance minister Wolfgang Schäuble, who issued a statement that he had “no concerns about Deutsche Bank.” Whether such statements provide reassurance remains to be seen, but the obvious point is that if everything were “rock solid,” there would be no need to make them.

Credit default swaps, a financial instrument used to cover potential losses, on Deutsche Bank bonds, show a greater risk of default than at any time during the 2008-2009 financial crisis.

In a bid to quell market concerns, the bank’s management is reported to be considering launching a €50 billion debt buyback operation. But the plan will only involve “senior bonds,” not riskier assets.

The fall in interest rates to negative levels is not the only source of turbulence. It is being compounded by a lack of knowledge of the major banks’ exposure to hedge funds that have invested in emerging markets, where debt problems are mounting because of the fall in commodity prices, led by oil.

Financial commentator Robert Gottliebsen noted in a comment posted on *Business Spectator* on Monday: “The banks have limited knowledge about what’s really happening inside the funds. And the global market gets the message and knows that somewhere around the world, there are huge losses in emerging country debts and energy loans. But the market is not sure just how big the losses are and who actually holds the bag. Fear of the unknown is a dangerous force in markets.”

What *is* known, he continued, is that as the oil price falls further and energy losses worsen, so emerging country problems will multiply.

Oil prices took another hit yesterday with a report by the International Energy Agency (IEA) declaring that the global oil surplus was bigger than previously thought, and a recent uptick in prices was probably a “false dawn.”

The price of Brent crude fell by 6.5 percent to $30.78 and West Texas Intermediate dropped by 4.5 percent to $28.34.

The views of the IEA are contrary to the position of the major oil producers, who have told shareholders they expect prices to rise later this year. “With the market already awash in oil, it is very hard to see how oil prices can rise significantly in the short term,” the IEA remarked.

If prices remain at their present levels, it will present major problems for hedge funds and other investors that have bet on a rise. “The tension in positioning is palpable,” one oil trader at a large bank told the *Financial Times*.

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