

# SUB-ZERO YIELDS AND RISKIER CREDIT IN EUROPE. SO WHAT'S YOUR INCOME STRATEGY FOR 2015?

24 Feb 2015

There is a strong incentive for the ECB to drive the record lows of Eurozone bond yields deeper into the ground as, inflation adjusted long term interest rates are too high for the region's moribund growth.

By lowering borrowing costs of very long maturities, the ECB encourages capital spending by governments. Given the favourable treatment the EU should give it to the budget, the ECB's avoids the risk of having to fight deflation through monetary means alone.

Without fiscal support, the deflationary risks posed to creditworthiness of indebted governments undermine fixed income's remaining selling point: capital preservation. It adds fuel to Greece contagion, subjecting peripheral bond markets to more volatility.

In Europe, equity dividend income may be a viable alternative to investors deprived of yield in fixed income. Equity Income ETFs with a strong emphasis on systematically screening and weighing stocks by dividends can offer the yield premium both fixed income and market-cap weighted benchmarks.

Investors sharing this sentiment may consider the following ETF: [WisdomTree Europe Equity Income UCITS ETF \(EEI\)](#)

Sub-zero yields-2



**Investors must take on more credit risk to attain any positive yield left**

Deflation and QE are driving bond yield in Europe into the ground. The Swiss 10Y government bond is negative, hovering around -0.1% (see chart 1). Looking outside Europe's safest safe haven, the German Bunds, the 5Y government debt issues of Austria and the Netherlands have recently entered negative yield territory, after their 2Y issues did so in the latter half of last year. Suppression has spilled over into corporates as well. The euro denominated 4 year corporate bonds of Nestle, the Swiss producer of cereals and chocolate, is now also negative.

In fact, bond yields of many large multinationals issuers are so suppressed that with almost no spread to account for over the yields of government debt, the large corporates have come to be regarded as the new safe havens. To get any yield, investors need to increasingly climb up the credit risk spectrum and consider lower, borderline investment

grade credit. It's a risky proposition, given that credit spreads between highly rated AA and borderline investment grade BAA has since 2012 more than halved.

### Confidence that deflation poses no risk to Europe's sovereigns is entrenched

If there was any yield to be had prior to QE, it was on the very long end of Europe's government bond curve. But QE has left a noticeable cut to bond yields there too. For instance, Spanish and Italian 30 year government bond yields fell sharply by around 60 bps, from the announcement of QE on Thursday 22 until Monday 26 January. It's an adjustment of very long dated maturities that in recent years have resisted falling as much as bond yields of shorter maturities. This, mainly because with the implicit guarantee put in place by the ECB's OMT program that pertained to maturities of 1 to 3 years, the very long maturities had become increasingly despondent to falling rates of inflation and the risk deflation poses to issuer's creditworthiness. Following the ECB's open ended, largely unconditional asset purchase program however, such lingering doubts by investors with very long investment horizons has now been eliminated. In other words, so long as the ECB continues to buy government debt, creditors' confidence of deflation posing no immediate risk to debtors' creditworthiness has become firmly entrenched.



Source: WisdomTree Europe, Bloomberg. Data to 31 January 2014

### Underneath low nominal bond yields lurk high, inflation-adjusted borrowing costs

There is an incentive for the ECB is seeking to suppress long term government bond yields much further. Because, when adjusted for the deflationary backdrop in the European continent, the real, inflation adjusted long term interest rates remain too high for the struggling peripheral, if not also for some of the core economies of Europe. As shown in chart 2, the long-term real interest rates in Spain and Italy are approximately 2% higher in real terms than in Germany. Having levels of real interest rates that are broadly similar, if not slightly higher than the levels that prevailed in the decade before the 2008 credit crisis when stronger growth accompanied sufficient inflation seems hard to justify in a time of no growth and deflation. In fact, the chart understates the real borrowing costs faced by peripheral Europe's small businesses as, gauging from the ECB's statistics on bank lending rates for new business loans of up to EUR 250 million alone, SMEs in Spain and Italy are charged interest rates well over 4% (which is close to 5% in real terms).

### Fiscal stimulus through incentivizing long-term capital spending

Given the 18.2 million unemployed workforce, the high borrowing costs charged to small businesses accounting for the overwhelming majority of employment must come down to align closer to the levels in Germany. For one, it restores their competitiveness with Germany. For another, it revives investment-led growth that leads to faster revival in the jobs market and importantly, creates the aggregate demand required by the ECB to win the fight against deflation.

Hence, the ECB's asset purchase program may instigate more fiscal stimulus. Seeing interest rates across long and very long horizons fall in real terms, governments would have an incentive to refinance debt over much longer maturities, thereby freeing up funds for increased capital spending which, as also laid out by the EU's investment plan, would be treated favourably in the budget calculation. Coupled with the EUR 21bn

in guarantees from the EFSI (European Fund for Strategic Investments) the private sector would, as hoped by the European Commission, have an incentive to co-invest in higher risk businesses and infrastructure projects. Loosening fiscal budgets as a means to stimulate investments would alleviate ECB's fears of having to fight deflation through monetary channels alone.

### **Europe's failure to offer fiscal support is the main deflation threat to bond markets**

If fiscal support remains absent, the ECB is at risk of failing to revive inflation. So far the bond market is giving the ECB the benefit of the doubt as it shakes off Eurozone's January falling headline and core CPI numbers, both pointing towards deflation becoming increasingly more entrenched. But when prolonged, the effect of deflation to deteriorating creditworthiness will become more evident in the declining tax take as the private sector is incentivized to cut back or delay spending. Meanwhile, the value of debt will continue to increase in real terms. In this context, the capital preservation argument will look less solid for investors looking to invest in zero and sub-zero yielding European fixed income markets. Especially surrounding the uncertainty of whether Greece can stay in the Eurozone as like it too, Italy and Spain are looking vulnerable amidst deflation increasing their already heavy debt burden. The heightened risks of a crisis of confidence spreading to those bond markets is already driving bond yields of Europe's safest safe havens deeper into negative territory. Hence, preserving capital into German, Austrian or Dutch government bonds are no longer cost free but come with a haircut.

### **The new fixed income: high dividend yielding equity baskets**

For as long as QE is expected to last, bond yields will stay suppressed for at least until 2016, and maybe beyond if the Eurozone cannot sustainably emerge out of deflation. For a buy and hold strategy in European's negative yielding fixed income market to make any sense today, investors must effectively price-in a prolonged period of deflation. But, as pointed out, deflation in itself can become a major destabilising force and undermine sentiment in bond markets.

Therefore, investors seeking an alternative to fixed income may increasingly find the dividend stream of quality companies a viable alternative. A broad basket of high dividend yielding stocks, weighted and rebalanced by the amount of dividends paid will offer investors a value-orientated strategy that not only offers a significant yield premium over government bonds, but also tends to offer yield premium over market cap weighted equity benchmarks (see chart 1). At a time when the Europe's fixed income markets can offer negative yields for safety or low yields for potentially significant credit risk, an equity income strategy that emphasizes cash returns as the best signal for transparency and shareholder value may serve as a viable alternative to investors.

Investors sharing this sentiment may want to consider the following UCITS ETF:

- [WisdomTree Europe Equity Income UCITS ETF \(EEI\)](#)

View the online version of this article [here](#).

Important Information

**Marketing communications issued in the European Economic Area (“EEA”):** This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

**Marketing communications issued in jurisdictions outside of the EEA:** This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.