Infomail
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Less Than Zero
The Upside Down World of Negative Interest Rates

"In Theory, there is no difference between theory and practice.

In practice, there is"

Yankee Great Yogi Berra

At the time of this writing, there are currently over a quarter of the world's government bonds trading at negative interest rates, pretty well guaranteeing a fixed loss for investors who hold them to maturity. 27% to be exact.

Global growth is pretty tepid and in most advanced economies, inflation is no where to be seen and growth is the weakest on record.

The Euro markets kicked off the negative interest rate phenomenon last summer, and were soon followed by Japan late in 2015. If recent central bankers' comments are any indication, we may be seeing more of them:

"I think negative interest rates are something the Fed will and probably should consider if the situation arises"

Ben Bernanke, Dec 2015

"*The bank is now confident that Canadian financial markets could also function in a negative interest rate environment"*

Steven Poloz, Bank of Canada Governor, Jan 2016

"We're taking a look at them (negative interest rates)….I wouldn't take those off the table"

Janet Yellen, Fed Reserve Chair, Feb 2016

Despite zero-interest rate policy (ZIRP) and numerous quantitative easing (QE) programs around the globe, the world's economies appear to be stuck in the doldrums. The US Q4 revised GDP number came in at an anemic + 1.0%, continuing to confirm that the current ongoing recovery out of the 2008-09 Great Recession, is the weakest on record. That's right, ever.

Therefore, given throwing all that money at economies didn't really seem to work, now the next step for the Keynesian economists who rule central banks everywhere is to make interest rates negative and adopt a "negative"- interest rate policy (NIRP).

The process can be as simple as the central bank charging member banks for excess reserves on deposit, or the same end can be achieved by manipulating repo markets.

In Europe, which has a head start, so far the banks are only charging large account holders for deposits. So these large accounts have been scrambling to move those dollars out of banks and into assets that do not depreciate, like high grade bonds, even if they are at negative rates and the customers will get less back than they invested.

Why the heck would anyone buy a bond which will be less at maturity than at investment, guaranteeing a loss? The answer is simple. The loss on the bond investment will still be less than the charge they would have incurred leaving it on deposit with the central bank. He/she loses "somewhat" less money.

Voila!

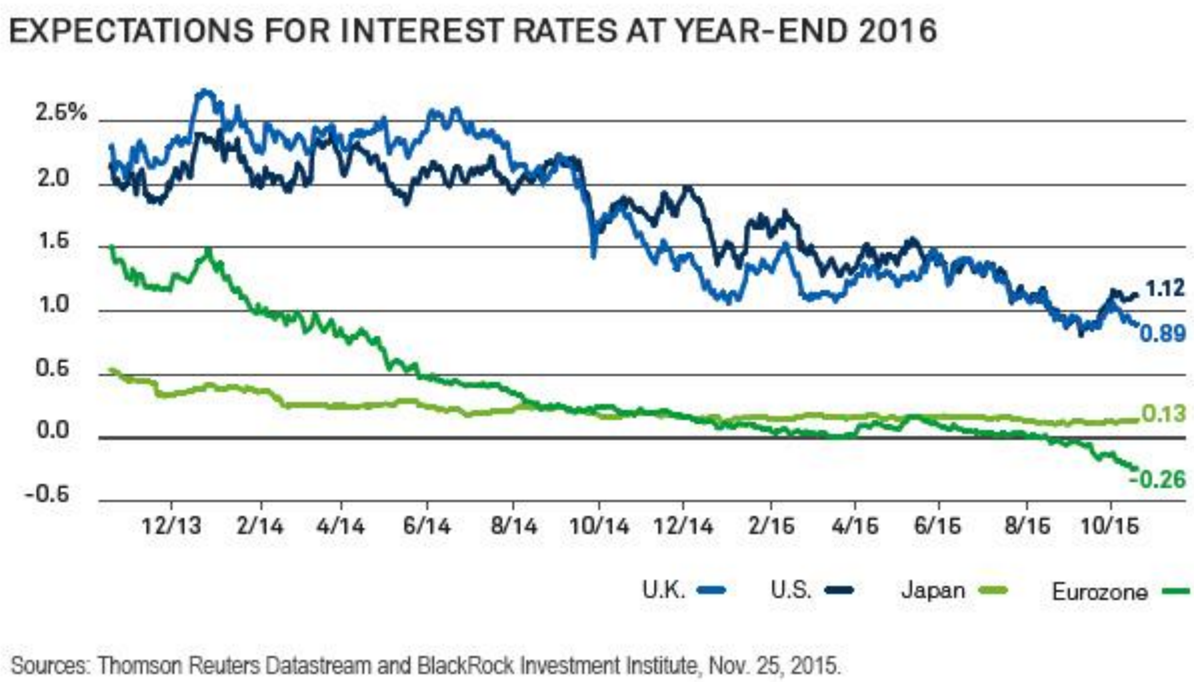
But in "theory", what the central banks really want is for the banks to lend the money to clients in the form of commercial and consumer loads, trying to create some velocity of money in the money. Even Yogi knew there's a difference between "in theory" and what happens in the real world.

Negative interest rates violate numerous tests of sound economics. They cause disequilibrium in capital markets between borrowers, savers and investors, and ultimately create an unintended consequence of procrastination in decision making especially in the areas of consumer consumption and manufacturing production.

Bottom line, throwing more money at what too much money created doesn't exactly solve the problem.

But in my research, I learned this was not the first use of negative interest rates. That's right, in the 1970's, the innovative country of Switzerland instituted negative rates in an attempt to DETER a flood of foreign investment. That's right they were trying to *prevent* capital from coming in! In 2009, Sweden became the first central bank to implement negative interest rates in the aftermath of the financial crisis.

At the moment, no central bank interest rates are deeply negative. The ECB deposit rate is at -0.30%. The German 10-year bond closed Friday at a yield of around 0.15%, and German yields are negative out to a maturity of 8 years.



The other argument of those who advocate for negative rates is that it puts pressure on a country's currency, increasing its competitiveness and boosting exports. If that's true, then Canada's economy should be booming with a 0.70 cent dollar.

Are negative rates working?

In Europe and Japan, it's been but six or so months they've been in place, so might be too early to tell, but financial markets continue to function adequately in both regions, but bank margins have been beat up and volatility seems to have risen. The Euro bank index is down 21% year to date while the Euro 600 index is down 9%.

Overall, the results to date appear mixed at best.

Should Canada revert to negative rates, it would also encourage riskier investment behavior. I would suspect Canadian real estate prices would most likely get a boost, but the already hot markets like Toronto and Vancouver would only get hotter.

There have also been whispers that the ECB in Europe is considering eliminating the 500 denominated Euro Note, the Eurozone's largest denominated bill. They portray it as a move to fight crime and to reduce money laundering but maybe they just want to make hoarding more difficult.

Some well-known economists in the USA have been lobbying for the demise of the of US $100 as well. I guess, because anyone carrying a pile of them could be confused to be a drug dealer.

Or could it be because hoarding cash, by definition is deflationary and it would undermine the Fed's efforts to fight deflation?

Let's face it folks, the world has been in a deleveraging mode since the Great Recession of 2008-09. Deleveraging, by its very being is deflationary. We've had several deflationary scares in recent memory:

- Summer 2013- Fed's Taper Tantrum
- Summer 2014- China/Commodity Collapse
- Summer 2015- Fed QE Exit Tantrum
- Winter 2016- Chinese Yuan Devaluation

From 2009 to 2013, he "risk on" trade has been encouraged by all the various forms of central bank stimulus Q1/Q2/E3 etc, etc….

Now, global financial markets need to wean off central bank stimulation, and it's causing a lot of displacements and volatility. The unintended consequence of all the QE's, is that there are less liquid envelopes of various asset classes.

The recent selling of Sovereign wealth funds in the first couple of weeks of 2016 enforced that belief. China's reserves went from $4 trillion to $3.4 trillion in 6 months. Increased regulation in the USA via BASIL rules, the Volcker rule, Dodd-Frank, etc. while having good intentions, are creating a liquidity accelerant and since there's less liquidity, there's less opportunity to hedge, which leads to…..bigger market swings and more volatility.

I've tried to explain what is going on with NIRP and its possible ramifications. In many ways, it's a Frankenstein type experiment by central bankers desperately trying to avoid deflation.

Did their actions after 2008-09 help prevent something worse? I believe so. But there are places where deflation is already set in. Greece for one, is already in a deflationary depression. Some emerging markets are on the brink given their massive taking on of debt, mostly denominated in US dollars.

The problem is, we are mostly in unchartered territory, and central bankers are trying to get creative with everything they have in the tool box. No one has the clear right answer as to what will work best, so in many ways, it's a trial and error type approach.

The world is vastly more complex than when any of these theories were devised decades ago. What would Yogi do?

Stay tuned,

Vito Finucci, B.COMM, CIM, FCSI
Vice President and Director, Investment Advisor
Associate Portfolio Manager