



A Negative What???

SYNOPSIS

- Late last week, Japan introduced negative interest rates on a portion of deposits held at their central bank.
- A negative interest rate was considered inconceivable a decade ago, but today, close to 25% of global government debt outstanding is yielding in the red.
- The pervasiveness of negative interest rates across the world has made government bonds a less suitable option for income-seeking investors.



Textbooks Are Being Rewritten

Japan's Central Bank (JCB) surprised investors by introducing negative interest rates last week. Although this decision only affects a small amount of deposits at the central bank, the implications are worth discussing.

The concept of a negative interest rate is one that would be considered unthinkable just a few years ago, yet today, close to 25% of all outstanding government debt now offers a negative yield. This phenomenon is literally causing financial textbooks to be rewritten.

Japan is not alone. Sweden, Denmark, Switzerland, the European Central Bank (ECB), and other smaller central banks are using negative interest rates for various reasons. In order to better understand the implications, let's answer some common questions about negative interest rates and why they have become so pervasive.

What is a negative interest rate, and how can an investment offer a negative yield?

An investment with a negative yield at the time of purchase is guaranteed to lose an investor money if held to maturity. In effect, the buyer is *paying* the bond issuer for the privilege of loaning it money, which is analogous to you paying interest on money you loaned to a friend.

Furthermore, imagine depositing your paycheck at the local bank knowing that they will *charge* you to hold your money. A bank is supposed to *pay* customers for deposits, pool it all together, and then loan it out in the form of mortgages, car loans, company lines of credit, etc. Charging depositors is completely backwards.

Comparing a bank to other business models simplifies this scenario. The interest



paid to depositors is similar to a company paying for supplies. Just as a clothing company buys cotton (supplies) to make shirts (products), banks need deposits (supplies) to make loans (products).

The difference between the price paid for deposits and the rate on a loan is how the bank makes money. If a bank sells a mortgage to a customer for 5% and pays depositors 1% for keeping money with the bank, the bank's profit is 4% ($5\% - 1\% = 4\%$) of the loan amount.

This "spread" between the mortgage rate and deposit rate can be thought of as the bank's profit margin. What's amazing about a negative interest rate is that a bank could theoretically make money from its suppliers. Imagine the clothing company getting paid by its suppliers to use their cotton. The notion is practically inconceivable!

Simply put, in the world of negative rates, banks charge for deposits, and investors that buy bonds with negative rates expect to lock in losses up-front (if held to maturity).

What is the role of a central bank, and why do they constantly move interest rates?

Think of a central bank as a bank for big banks. For example, Bank of America and J.P. Morgan are "customers" of the Federal Reserve in a similar way that we are customers to them.

We use banks to deposit paychecks and take out loans to buy houses and cars, and these large banks rely upon the Fed for similar needs. Banks use central banks to (1) hold excess cash and (2) take out loans periodically to help support their business.

A central bank's key objectives are to control both the rate of inflation and economic growth over time. They are constantly trying to find the right balance of the two, and altering access to money is their primary tool to accomplish this goal.

Think about how most consumers buy expensive goods and assets. Rarely do we pay for homes, cars, educations, and other big ticket items in cash. Instead, we take out loans and then pay back these debts over time. Since these purchases are mostly done on credit, interest rates are the primary driver for the *potential* for economic growth.

Meaning, if the mortgage rate rises from 4% to 10%, house sales will probably get hit because far fewer consumers can afford to pay a higher interest rate on a large loan balance. Control interest rate levels and you control how fast/slow an economy can grow.

The Fed's primary means of controlling interest rates on loans is by the altering the interest rate they charge big banks for (1) their deposits and (2) loans made to them. If the Fed wants to slow down the economy to combat rising inflation,



they increase these rates to big banks, which will (1) earn banks a higher risk-free return on funds deposited with the Fed, and (2) make loans to big banks more expensive and subsequently less attractive.

More big bank cash will be deposited at the Fed, which will decrease the supply of money available to bank customers for loans. The rise in the cost of a loan to a big bank will also be passed along to consumers, which slows down the economy.

NOTE: *This situation is no different than any other industry that can pass along price increases to its customers. If a gas station is forced to pay more for fuel due to rising oil prices, they will increase the price at the pump to maintain profitability. Banks effectively do the same.*

On the flip side, when the Fed wants to encourage economic growth, they will lower both the rate they pay big banks on deposits and loans made to them. Big banks will then withdraw money from the Fed and go search for higher returns by loaning to their own customers. The rise in the supply of money available for loan causes the price of a loan to fall. More attractive loan rates lead to more buying, which pushes economic growth higher.

Hence, these interest rates charged by the Fed to big banks are the primary tool for a central bank to control economic growth. Nearly all central banks in the world operate in a similar manner to the Fed, and Japan is no exception.

How did negative rates appear, and why would a central bank want such an outcome?

The problem with central bank action is that their tools do not always work. The JCB is a prime example because their use of low interest rates to fight decades of stagnant growth has failed. Extreme times call for extreme measures, and here's where negative rates come into play.

The JCB is now *charging* big banks to deposit money with them in the same manner as our hypothetical scenario discussed earlier. Their central bank is so desperate to stimulate the economy that they are effectively forcing banks to loan money or else lock in a loss. It's crazy.

On the other hand, Sweden and Denmark are using negative rates as a way to weaken their currencies. As a currency weakens, that country's exports become more attractive in the same manner that a European vacation becomes more attractive to Americans when the Euro weakens against the dollar. Higher exports, much like cheaper loans, lead to economic growth.

Simply put, these central banks are so desperate for growth that they are doing all they can to incent banks to make more loans and keep their currencies weak relative to others.

Why would any rational investor accept a negative yield on an investment?



Three reasons explain why an investor would consider a negative yield. The first is a “flight to safety.” Risk averse investors may not be happy with locking in a loss, but some argue that a certain small loss is better than exposing themselves to larger losses elsewhere.

The second reason is best explained by dissecting the profit from a dividend paying stock, where the sum of the (1) yield and (2) price appreciation determine the total return.

If an investor purchased a \$20 stock that paid a 5% annual dividend and then sold a year later at \$25, then the total return would equal the dividend plus capital appreciation in the stock price:

Capital	$\$25 - \$20 =$	$\$5$
Appreciation:		
Dividend:	$5\% \text{ of } \$20$	$\$1$
	$=$	
Total Value:	$\$5 + \$1 =$	$\$6$
Percentage Gain:	$\$6 / \$20 =$	30%

The same return calculation applies to the bond world. Investors can sell bonds prior to maturity, and the value of this bond changes over time due to a myriad of forces such as interest rate movements, inflation levels, investment climate, etc.

Those buying government bonds with negative interest rates are doing so because they believe that the potential for capital appreciation on the bond will more than make up for the loss from the negative yield.

For example, if a government bond yielded -0.5%, but had the potential for 10% in capital appreciation, then the investor still stands to profit 9.5% ($10\% - 0.5\% = 9.5\%$).

The third reason centers around regulation enacted since the financial crisis. Large banks, insurance companies, and other entities deemed critical to the stability of the global financial system are now required to hold significantly more “ultra-safe” assets than prior to 2009.

With exception to U.S. Treasury bonds and bills, the government bonds from those countries offering negative interest rates are still some of the safest assets in the world. The current regulatory environment caused the demand for risk-free assets to explode, and in a twist of irony, forced these large institutions to lock in some guaranteed losses up front.

Will negative interest rates ever impact my bank account?

Although it's never wise to bet on the future direction of a government decision, the odds of negative interest rates impacting consumer bank accounts in the form of negative deposit rates is extremely low. The political ramifications would be unthinkable, and the JCB and other central banks have explicitly stated that



consumers will not be directly impacted by their decisions.

Banks can't operate without your deposits, and most of us don't have enough money where a bank would benefit financially from the ill-will generated by such a move.

What are the implications for everyday investors?

Retail investors owned government bonds for decades as a way to earn income from risk-free investments. Those who could not stomach volatility of any kind found solace in these products because the return was known at the time of purchase as long as (1) the bond was not sold prior to maturity and (2) income received was reinvested around the same coupon rate.

Unfortunately, the days of easy income are over, and we are left with a market that looks dramatically different than just ten years ago. This new world of ultra-low/negative interest rates demands a revised strategy, and those who refuse to adapt risk harming their nest eggs. Within this context, investors should do the following:

1. **Prepare for Lower Returns:** The days of 5-8% on ultra-safe investments are gone, and investors must expect lower returns for the foreseeable future. Those not yet retired should start saving more today. Current retirees need to have an income plan that involves more than just risk-free investments.
2. **Don't Own Government Bonds for Income:** The 10-year U.S. Treasury yields 1.9%, and the 30-year Treasury yields 3%. These numbers sound paltry but are appealing to the rest of the developed world. Germany's 10-year government bond yields 0.27% and its 30-year bond is 1%. Japan's 10-year is 0.06% and its 30-year is also 1%.
3. **Remain Diversified:** Although these investments are unattractive on an income basis, diversification demands some exposure because the safety component still matters.

The bottom line is that relying solely on government bonds is no longer an appropriate savings strategy for everyday investors.

If these products are no longer suitable, should I sell my existing government bonds?

Investors who own government bonds should not blindly sell them without talking to their financial advisor. For example, if an investor is generating returns that exceeds inflation, then there may be no reason to eliminate that income stream.

Should I be worried?

Two common fears associated with negative interest rates are they (1) signal desperation by a central bank and (2) incent consumers to withdraw cash and stuff it under mattresses. I agree with the first but not the second.

The problem with the use of negative interest rates is that they do not fix structural problems in economies. The Fed's decision to keep interest rates



artificially low actually failed for similar reasons. Their goal was to lower unemployment, but our country's issue is also a structural one in that the supply of attractive labor does not meet the demand. Said another way, artificially low interest rates did not and will not teach someone how to write software code.

Hence, these moves do signify desperation, but far more concerning, they represent politics at its worst. Despite these leaders having an arsenal of weapons, elected officials have chosen to bring knives to a gun fight for fear that the guns could end their careers.

Difficult decisions by elected officials must be made to eliminate these structural and cultural headwinds. Japan has suffered from low growth and deflation for two decades, yet their labor laws are a disaster, the population is aging as productivity continues to fall, and its economy remains closed. These can be solved, but negative interest rates are butter knives in this fight.

Where I disagree is the notion that negative interest rates would cause a large-scale bank run, because there's nowhere else to store money. Any minute that cash is not in a bank is a minute that it risks getting stolen, burned, ripped, misplaced, etc. That risk is far too high for most.

The net effect is one that should not concern investors for the time being because these problems in other parts of the world won't impact Americans too much. If anything, we may even benefit as capital leaves these countries and arrives here in search of better relative returns.



Sincerely,

Mike Sorrentino, CFA
Chief Strategist, Aviance Capital Management
mikeonmarkets.com

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