DEEP UNDERCURRENTS

How will negative interest rates change the rules of the game for investors and policymakers?

By John Rubino

Illustration by Matt Harrison Clough

In early 2015, Switzerland's interest rates turned negative. Not for one year. Not for five years. But all the way out to 10 years, meaning that virtually everyone desiring to park their cash in safe-haven Swiss francs had to pay for the privilege.

And Swiss bonds weren't unique. Yields on French and German sovereign debt went negative out to five and seven years, respectively, while the overnight Euro Interbank Offered Rate (Euribor), which had averaged about 2% for the previous couple of years, fell below zero and stayed there. By the end of 2015's first quarter, paper accounting for 31% of the Bloomberg Eurozone Sovereign Bond Index was trading with negative yields.

Even more startling than the numbers was the timing. This plunge in rates occurred in the sixth year of a recovery during which most of the developed world had run record fiscal deficits, cut interest rates aggressively, and created vast amounts of new currency.

Traditional economic theory says that a combination of massive deficit spending and historically low (not to mention negative) interest rates should produce a rip-roaring boom in which workers get generous raises, prices spike, and interest rates follow. Theory also says that, even in the rare case of nominal interest rates turning negative, the rates can't stay there because beyond this "zero bound," savers and investors will withdraw their cash and store it themselves, emptying banks and crashing the financial system.

Recent events have challenged both of these assumptions while sparking a debate over the nature and the import of this collapse in yields. Specifically, is it a brief aberration or the beginning of an unfamiliar and potentially treacherous new normal?

"NOT A BUSINESS CYCLE THING"

Multiple factors provide possible explanations for this curious situation. Three in particular stand out: demographic changes, the impact of debt burdens, and uncertain implications of monetary policy (especially quantitative easing).

AN AGING POPULATION EQUALS LOW INTEREST RATES. "Baby Boomers are preparing to retire and are catching up on their retirement plans," says Shane Shepherd, senior vice president and head of macro research with investment firm Research Affiliates in Newport Beach, California. "So there's a shift towards increased savings"—in which safety trumps profit and savers are willing to accept negative interest rates as, in effect, a storage fee for their money. And because such demographic trends unfold slowly, Shepherd adds, "This is not a short-term issue. We expect lower interest rates for an extended period of time."

BEYOND A CERTAIN POINT, DEBT IS DEFLATIONARY. Loans have to be repaid with funds that might otherwise go toward investment and consumption. Today's unprecedented levels of debt thus create an economic headwind that requires commensurately forceful policies (including negative interest rates) to induce more borrowing and spending.

"People and governments are now leveraged to the hilt, which translates into lower demand, slower growth, and lower interest rates," says Shepherd. Here again, "This not a business cycle thing. It's structural."

QUANTITATIVE EASING, BELIEVE IT OR NOT, IS ALSO DEFLATIONARY. When central banks buy bonds with newly created currency, they hand commercial banks more reserves with which to write loans. But the experimental and therefore

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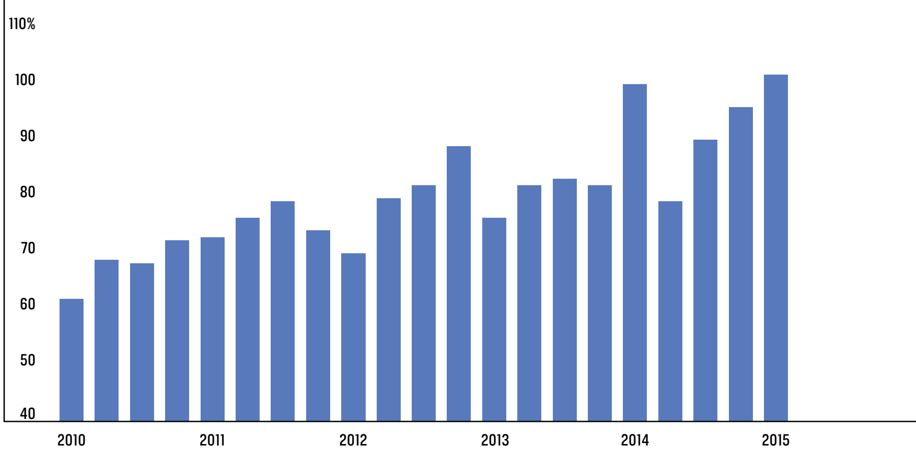
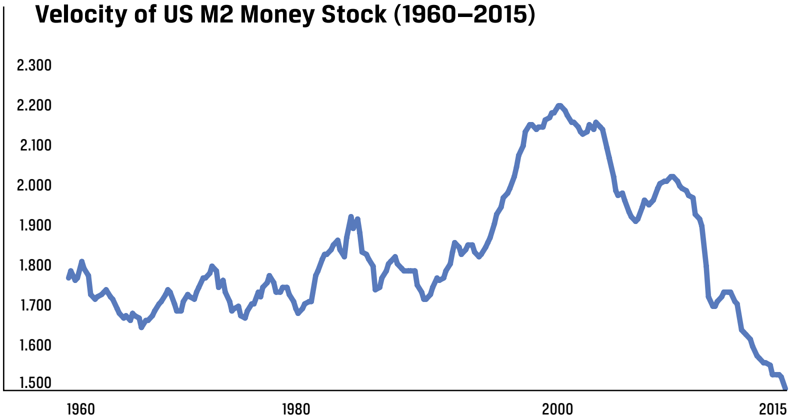
S&P 500 Quarterly Share Repurchases plus Dividends as % of Operating Earnings (2010–2015)



Note: 2015 data for first quarter only. *Source:* Based on Bloomberg data.



Source: Based on St. Louis Federal Reserve data.

unpredictable nature of these programs is making businesses reluctant to invest, says Keith Dicker, CFA, president and chief investment officer of IceCap Asset Management in Halifax, Canada.

Because policymakers are improvising, "It's impossible to know what future monetary policy will be," says Dicker. "In that environment, will you open a new plant in France? Probably not."

The combination of rising reserves and reluctant borrowers leaves banks with far more money than they need, concludes Gerald Jensen, CFA, finance professor at Northern Illinois University and co-author of *Invest with the Fed: Maximizing Portfolio Performance by Following Federal Reserve Policy.*

"Historically, bank excess reserves (funds deposited with the central bank rather than being lent out) averaged less than 3% of total reserves," says Jensen. "Currently in the US, that number is 95%. So banks have little incentive to offer higher rates to attract or keep customer deposits."

Confirming this vision of capitalism's animal spirits being held in check by debt, demographics, and uncertainty are trends for US corporate dividends and share repurchases—that is, the return of corporate cash to investors. (See the accompanying charts on share repurchases and money velocity.) Dividends and repurchases have recently exceeded capital spending, implying that large companies see little need for new productive capacity. And the velocity of money (the rate at which currency, once created, is spent) continues to fall. The story is similar in Europe and Japan, where business investment is anemic and GDP growth rates of 1% or below are the norm. The upshot? Most major countries still require extraordinary help to generate even modest growth.

MORE EXPERIMENTS COMING?

Current policies may eventually produce faster growth and normalized interest rates, making the recent dip into negative yields nothing more than a historical curiosity. By mid-2015, there were in fact some modest signs of progress, including upticks in developed-world growth and slightly higher long-term interest rates in Germany and the US. But if these trends peter out (as has happened several times previously in this cycle) and growth remains too slow to reverse the upward march of debt/GDP in developed economies, how will a negative-interest-rate world respond? Two scenarios seem likely.

THE WAR ON CASH. Pushing interest rates even deeper into negative territory might induce more borrowing and spending, but it comes with the risk of a mass migration out of bonds and savings accounts and into cash. In response, governments and banks around the world are attempting to marginalize cash (physical currency and deposits) by making it harder and/or less attractive to hold. In early 2015, JPMorgan Chase forbade some customers from storing cash in safe deposit boxes. Swiss banks refused to allow pension funds to withdraw large amounts of cash from their accounts. Danish legislators proposed a law allowing shops to refuse to accept cash payments. Australia imposed a 0.05% tax on some bank deposits. And France cut the legal limit on cash payments from 3,000 euros to 1,000 euros.

Justifying this war on cash, University of Wuerzburg economist and German Council of Economic Experts member Peter Bofinger recently told *Der Spiegel*, "With today's technical possibilities, coins and notes are in fact an anachronism … Central banks cannot push interest rates appreciably below zero because savers would hoard cash. *If there is no cash, the zero bound is eliminated*" [emphasis added].

HELICOPTER MONEY. In former Federal Reserve chairman Ben Bernanke's now-famous 2002 speech, he observed that deflation was impossible because modern central banks can create unlimited amounts of currency and, if necessary, drop it from helicopters.

"They've tried everything he mentioned in that speech—except the helicopter drop," says Shepherd. "In practice, this would be a coordination between monetary and fiscal policy of the major countries. You cut taxes, create a fiscal deficit, and finance it with newly created money." Tax refunds would be spent, money velocity would pick up, and inflation would rise to the 3% rate that makes current debt loads manageable, he predicts.

"ENTRENCHING INSTABILITY"

One obvious side effect of negative interest rates is that they compel retirees, pension funds, and others who need positive cash flow to move further out on the risk spectrum, says Jensen. "Rather than accepting extremely low rates in government bonds, many fixed-income managers choose high-yield bonds, emerging market debt, and high-dividend equities." The result, according to Jensen, would be "a broad-based fixed-income asset bubble."

In a June 2015 report, the Bank for International Settlements echoed this sentiment by concluding that a policy of persistently low interest rates "runs the risk of entrenching instability and chronic weakness." Such an environment makes several extreme—and, sometimes, mutually exclusive—scenarios at least conceivable.

SAFE-HAVEN TSUNAMI. While interest rates are either very low or negative in countries that are perceived to be safe bets, they've spiked in many other places, notably emerging markets and the eurozone periphery. In mid-2015, as shown by the chart on sovereign bond yields, a gulf separated safe-haven and high-risk sovereign debt.

If these trends continue or another financial crisis occurs, the flow of capital away from risk and toward safety could become a tsunami, sending Japanese, German, and US bond yields even lower. But according to Dicker, given the eurozone's ongoing struggle to merge its heterogeneous members into a single economy and Japan's debt/demographic challenges, the US dollar might pull away from the pack, drawing the lion's share of global capital flows and rising against all other currencies.

Such a scenario would be fine for the owners of Treasury bonds and Manhattan real estate, but it would be a serious problem for those unlucky or unwise enough to *owe* dollars. "Any country that's borrowing dollars and running [its] economy in a different currency will have trouble paying off or rolling over its debts," predicts Dicker. This group includes a big part of the developing world, where approximately US$9 trillion of dollar-denominated debt was outstanding in mid-2015. "Countries that maintain control of their currency will see negative real rates," says Dicker. "Those that lose control of their currency and, in effect, the ability to borrow will see hyperinflation."

Meanwhile, "Most bank and insurance company regulatory capital is mandated to be in sovereign debt, which makes them very vulnerable," says Dicker. "In the eurozone especially, banks can use the bonds of any member state as risk-free capital. How can Italian debt equal German debt?" The answer is that in a crisis it can't, and the divergence of high- and low-quality paper might translate into extreme volatility for bank earnings and market valuations.

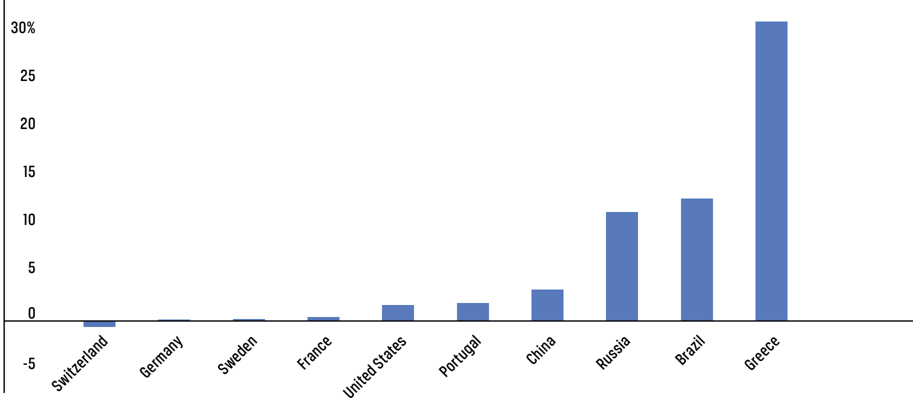
In this hypothetical world where safe-haven debt is golden and everything else is suspect, yield becomes irrelevant, says Dicker. "I'd be trying to preserve capital and make a return on the currency side." That is, investors will for a time be willing to buy safe-haven debt regardless of the coupon in exchange for exposure to an appreciating currency. If a 10-year Swiss franc bond, for instance, yields negative 1% but the franc appreciates by 10%, the resulting 9% total return would make a pension fund's trustees very happy.

BROAD-BASED BEAR MARKET. In a sense, because stocks and bonds compete for the same pool of capital, each asset class justified the other's rich valuations in mid-2015. But if the bond bubble were to burst (for instance, as a result of a helicopter money policy reigniting inflation and sending interest rates higher), then the multiple that applies to stocks would logically fall. In that case, "you'll see stocks and bonds both deliver negative returns over time. That's a very bad place to be if you're only in those two asset classes," says Shepherd.

In this scenario, high-grade debt might actually underperform lower-quality paper, as evidenced by the mid-2015 mini-spike in German bund yields. "To go from 4 basis points to 75 [on the 10-year bund] is enormous, a lifetime of volatility," says Bill Laggner, partner with Dallas, Texas investment firm Bearing Asset Management. "You don't have to pay much to short a bond with a minimal or negative coupon. The cost of shorting Spanish or Italian debt is considerably higher." Put another way,

[NEGATIVE INTEREST RATES] COMPEL RETIREES, PENSION FUNDS, AND OTHERS WHO NEED POSITIVE CASH FLOW TO MOVE FURTHER OUT ON THE RISK SPECTRUM. … THE RESULT, ACCORDING TO JENSEN, WOULD BE "A BROAD-BASED FIXED-INCOME ASSET BUBBLE."

Five-Year Government Bond Yield for Key Countries
(as of 6 July 2015)



Source: Based on data from Trading Economics.

> "COUNTRIES THAT MAINTAIN CONTROL OF THEIR CURRENCY WILL SEE NEGATIVE REAL RATES. THOSE THAT LOSE CONTROL OF THEIR CURRENCY AND, IN EFFECT, THE ABILITY TO BORROW WILL SEE HYPERINFLATION."

in both equities and fixed income, the highest flyers might have farthest to fall, and negative-coupon bonds "might be the short of a lifetime," says Laggner.

EQUITIES REPLACE BONDS AS THE GLOBAL SAFE HAVEN. A bursting bond bubble would send a torrent of capital in search of a new home, and the shares of multinationals that can operate globally, raise prices sufficiently to cover their costs, and increase their dividends regularly might look safer than virtually any government's debt. "There's a high probability of having a strong equity market at the exact point in time when the world is heading into a global recession," says Dicker. This scenario would mean, for a while at least, that the prices of blue-chip equities could rise without regard for traditional valuation measures.

GOLD AND CRYPTOCURRENCIES SEIZE THE MOMENT. "Gold is the only form of money without contingent liabilities," says Laggner. In other words, no government or bank has to keep a promise for the metal to maintain its value, which has made it a traditional safe-haven asset in troubled times. Consequently, rising inflation, a bursting bond bubble, or any number of other shocks to the system "could lead wealthy people to view gold as portable wealth, along with art and jewelry," says Laggner. And even in the absence of financial instability, negative interest rates are potentially good for gold: "It costs around 1% a year to store bullion, which is not an attractive deal when high-quality bonds yield 6%. But when bonds are yielding negative 1%, gold looks much better in relative terms," says Laggner. In his view, given the vast amount of capital that might (in some of the above scenarios) be looking for a secure home, the impact on the metal's price could be notable.

Meanwhile, technology has tossed a wild card into the game in the form of cryptocurrencies (such as bitcoin, which bypasses national currencies) and gold-based payment systems (such as BitGold, BitReserve, and Euro Pacific Bank, which allow account holders to store gold bullion and spend it via debit cards and smart phones). The latter are "PayPals for gold" that represent "a whole new way to own and transact with precious metals," says Laggner. Should they become popular alternatives to negative-interest-rate cash instruments, he points out, "then the central banks have really lost control."

John Rubino, a former financial analyst, is a freelance writer and author of several books on investment topics.