Use It or Lose It

Every time investors believe global central bankers are running out of ammunition to fight sluggish economic growth, policymakers return to the theoretical drawing board, adopting increasingly radical policies that economists can "prove" work in theory, but have minimal practical evidence will work outside of the lab. One of the more recent experiments surrounds the adoption of Negative Interest Rate Policies ("NIRP"). NIRP sets official short-term policy rates - the rates central banks pay on excess bank reserves - below zero, in effect taxing banks for exceeding their reserve requirements. The thought process is simple, if banks have to pay to store their cash, they should be motivated to lend any excess cash to businesses and consumers, propelling economic growth. Essentially, the message from central banks regarding excess reserves is clear - Use it or lose it.

While the theory sounds reasonable, certain repercussions border on absurd because short-term policy rates are the initial building block of the financial economy. On April 14th, the Wall Street Journal published an article entitled "Negative Rates Around the World: How One Danish Couple Gets Paid Interest on Their Mortgage." As I read the article about the young Danish financial consultant that is receiving interest payments on borrowed monies, my initial reaction was…How can I leverage my debt!? My next reaction was….Wow, the system is broken.

Banks normally set the rate they pay on deposits based on the short-term policy rate. Imagine a world where individual bank balances are essentially "taxed" with negative interest rates. A $1,000 deposit on January 1st is only worth $990 at year-end because of a 1% negative interest rate. The obvious solution would be to withdraw your cash and store it in the mattress, but that certainly involves risk. Other more creative ways a saver could safely earn zero on their cash might include (1) overpay your taxes and collect the refund; (2) maintain a credit balance on your credit cards; or (3) get a certified check from the bank made payable to yourself.

Thus far, banks have been slow and selective in pushing the central banks' "use it or lose it" ultimatum down to individual depositors, fearing the potential withdrawal consequences noted above, causing bank earnings and stock share prices to decline. However, at some point additional pressure on bank profitability will inevitably force managements to review all options.

Currently, five central banks have taken this "backward" path; the European Central Bank (ECB), Danmarks Nationalbank (Denmark), Swiss National Bank (Switzerland), Riksbank (Sweden) and most recently the Bank of Japan. Unlike Denmark and Switzerland that have utilized negative interest rates in the past to manage currency valuations, the ECB and Bank of Japan motivations are economic growth initiatives to fight slow growth and more importantly stubbornly low inflation.

Why is inflation so important? Inflation is a primary factor in many consumer spending decisions. When inflation is rising, consumers are increasingly motivated to spend sooner rather than later to protect the purchasing power of their money (another "use it or lose it" policy). An extreme example occurred in the Weimar Republic (modern-day Germany), which experienced hyperinflation following World War I. In his October 15, 2008 memo, "The Limits to Negativism," Howard Marks relays the story of his friend, Henry Reichman, who was a busboy in a Berlin restaurant during this period. Mr. Reichman said that he used to be paid at lunchtime and would immediately run out to spend his salary, since it would buy less if he waited until after work to shop.

Conversely, low inflation, or more damaging deflation, allows consumers to put off spending decisions with minimal consequences, creating significant obstacles to reigniting economic growth engines.

Could we see NIRP from the Federal Reserve?

Recently Federal Reserve Chair Janet Yellen said she "would not completely rule out the use of negative rates in some future very adverse scenario." While no policy is completely off the table, I feel the chances of NIRP in the U.S. are very low for the following reasons:

Relative strength of U.S. economy - The U.S. economy is notably stronger than those of Europe and Japan. Growth, while not robust, has been consistently positive. Despite deflationary pressures – collapsing oil prices and a strong U.S. dollar - inflation has been steadily moving toward the Fed's 2.0% target.

Limited effectiveness - While it is only a limited number of data points, the early indications have not provided much evidence that negative interest rates are promoting economic activity in Europe or Japan. In fact, the reaction in Japan has been counterproductive with the yen surging to an 18-month high and risk aversion climbing, both significant headwinds to economic growth.

Structural complications – Money market mutual funds play a vital role in the U.S. short-term funding markets (T-bills and commercial paper). Low interest rates have wreaked havoc on the system as money market funds are squeezed to cover their operating expenses. Despite money market structural reforms, negative interest rates could sink the money market industry, creating numerous unintended liquidity consequences.

Legal complications – Most people incorrectly assume the Federal Reserve can essentially do whatever it wants. While in favor of considering NIRP, former Fed Chair Ben Bernanke, questions whether the Fed can legally compel banks to pay them a fee for holding overnight cash.

Federal Reserve spotlight – Negative interest rates are very unpopular within certain powerful segments of the population, most notably the financial sector. Unpopular policy decisions, even if they are in the country's best long-term interest, inject political risk into the discussion, exposing the Fed to greater scrutiny by politicians and potentially jeopardizing its much-cherished operational autonomy.

Other options – If the Federal Reserve is forced to take additional action, I believe it would revive its quantitative easing program and consider other options before taking interest rates negative.

Investment Implications

I believe investors are willing to tolerate unconventional monetary policies to a point, but eventually those policies look like desperation. Fundamental concerns and doubts emerge as central bank credibility is questioned. With each new unconventional policy, it seems the economic benefits decrease while the economic costs increase.

The most obvious implication of NIRP and other unconventional monetary policies is lower bond yields for longer. It should be noted, NIRP only refers to short-term policy rates. Longer-term government bonds across Europe and Japan were already trading with negative yields primarily driven by previous quantitative easing programs by global central banks. Fitch Ratings reported that as of April 25, 2016 the total amount of negative yielding government debt stood at $9.9 trillion with Japan accounting for nearly two-thirds of that total. While I don't anticipate NIRP within the U.S., global central bank policies will clearly be felt across the Treasury yield curve as foreign demand for U.S. Treasuries will remain elevated, potentially leading to a flatter yield curve should the Federal Reserve continue its rate normalization process.

For investors that have even modest return objectives, lower bond yields/returns will continue to push investors into risky asset classes out of necessity (need higher returns), not conviction. Taking risk without conviction can exacerbate market movements as investors' emotions do not have a fundamental foundation to support them during difficult market environments. I believe this overly emotional environment contributed to the market's dramatic sell-off earlier this year and am confident many investors experienced permanent losses by anxiously liquidating portfolios and missing the market's rebound.

Global stock markets have now experienced two separate 10% corrections in the last eight months and I anticipate equity volatility will remain high. Against this backdrop, we continue to stress broad diversification, while emphasizing a long-term plan that matches liquidity needs with the portfolio's time horizon. Where appropriate, we have incorporated modest exposures, directly and/or indirectly, to inflation-sensitive assets, believing that central banks will eventually be successful in their efforts. We are maintaining exposures to unconstrained flexible strategies/managers that base their risk-taking on conviction. Finally, we are constantly searching for new strategies/opportunities that can help portfolio's overcome a potentially lower-return headwind, especially within fixed income markets.

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