In this issue

Why So Negative?

Yields on Treasury bills briefly turned negative back in March. Given that so many other countries have tried using negative interest rate policies for years with little success, is the U.S. headed into a downward spiral?

Twilight Zone

You are about to enter another dimension, a dimension not only of sight and sound but of mind. A journey into a wondrous land of imagination. Here, you pay a bank to hold your money and that bank pays you to take out a loan.

While this may sound like the intro to an episode of The Twilight Zone, it's happening globally right now. The idea of a negative interest rate was once laughable, yet today, trillions in government debt trades with a negative yield. The side effects of these policies have only begun to take shape.

For example, Denmark's third largest bank began offering mortgages at a negative interest rate of -0.50% back in August 2019 (1). Meaning, if someone bought a house for $1 million and paid off the mortgage in 10 years, they would pay back $995,000. As of May 6th 2020, loaning money to the German government for 10 years will cost you 0.51% (2). Loaning them money for 30 years will cost you 0.07% (2).

Back in the U.S., yields on select Treasury bills briefly turned negative during the March panic, as investors sold risky assets (3). What was once unthinkable – that the U.S. would follow the same path as Europe and Japan – has prompted investors to ask what will happen next. Will we one day have to pay banks a storage fee to hold our cash? Will we see negative rate mortgages? How will this impact those who need income?

In order to answer these questions, let's first discuss the concept of negative interest rates and why they became so pervasive.

Why Is This Happening?

Banks pay customers for deposits, pool them together, and then sell mortgages, car loans, company lines of credit, etc. Interest paid to depositors is similar to a company paying its suppliers. 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 for 5% and pays depositors 1%, the bank's profit is 4% (5% - 1% = 4%) of the loan amount.

Charging depositors to hold their cash is as backwards as a clothing company getting paid by its suppliers to use their cotton. But Japan's central bank has been doing this since 2016 as a way to encourage loan growth. Big banks deposit excess cash at central banks in a similar manner to how consumers use their local bank, so the Bank of Japan (BoJ) gave banks a choice. Either loan more money to customers or else pay a "storage fee" to keep that cash deposited at the central bank.

Sweden and Denmark have been using negative interest rates as a way to weaken their currency to make exports more attractive (similar to how a European vacation becomes more attractive to Americans when the euro weakens against the dollar). Higher exports, much like cheaper loans, fuel economic growth.

The European Central Bank (ECB) is worried about all of the above. In an attempt to prevent Europe from falling into a deflationary spiral and keeping the euro low enough to help export-heavy countries like Germany, this central bank has used negative rates since 2014 (4).

Simply put, central banks are using negative rate policies in a desperate attempt to stimulate their economies.

Who's Buying?

An investment with a negative yield at the time of purchase will lose money if held to maturity. In effect, the buyer is *paying* the issuer for taking their money (analogous to paying a friend to borrow your money). There are three reasons why an investor would buy a negative-yielding bond.

The first is "flight to safety." Risk averse investors worry more about return *of* capital than the return *on* capital. They may not be happy with locking in a loss, but some argue that a certain small loss is better than a potentially larger loss elsewhere.

The second reason can be explained by dissecting the profit from a dividend paying stock, where the *total return* equals the sum of the yield and price appreciation.

If an investor purchased a $20 stock that paid a 5% annual dividend and then sold a year later at $25, the *total return* would be:

Capital Appreciation:	$25 - $20 = $5
Dividend:	5% of $20 = $1
Total Return:	$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 bond prices fluctuate over time due to a myriad of forces such as interest rates, inflation, etc.

Those buying bonds with negative interest rates may think that the potential for capital appreciation will exceed the loss from the yield. For example, if a bond yielded -0.5%, but had the potential for 10% in capital appreciation, then an investor still stands to profit 9.5% (10% - 0.5% = 9.5%).

The third reason involves regulation enacted since the financial crisis. Large banks, insurance companies, and other entities deemed critical to the stability of the global financial system are required to hold more "ultra-safe" assets.

Government bonds from many countries offering negative interest rates are still viewed by the regulators in those countries to be some of the safest assets in the world. Therefore, whether these entities like it or not, they are forced to hold them.

The Bottom Line

What sent rates negative in the U.S. is quite different than what's been going on in Europe and Japan. Here, the bond market drove yields negative on risk-free assets in the midst of a panic. This was nothing more than a surge in demand for a fixed supply of bonds (as the price of a bond rises, its yield falls). It was a *natural* phenomenon that occurred in a market driven by bond math.

Monetary policy that targets negative interest rates is manufactured. It's an arranged marriage that is forced upon its victims. These countries have run out of politically safe options to stimulate their economies and have now resorted to an ultimatum – either loan money or else.

The deeper central banks go into negative territory, the more perverse the effects (like negative interest rate mortgages). Unsurprisingly, this has done little to incent consumers to spend more money or businesses to hire more workers. Ultimatums rarely inspire obedience, nor does desperation instill confidence. Furthermore, most of the problems these countries face are structural ones that likely cannot be solved using monetary policy.

For example, Japan has suffered from low growth and deflation for two decades because their labor laws are a disaster, the population is aging as productivity falls, and its economy remains closed. Using monetary policy to address these problems is like injecting penicillin to kill a virus.

The question then becomes whether the Fed will follow suit and adopt a negative rate policy (something President Trump and others have advocated (5)). The Fed already dropped their target interest rate to zero and injected record amounts of stimulus. Betting markets see a chance of it happening by next year (5). That being said, it is unlikely the Fed will cross that line for a couple reasons.

First, countries are using negative interest rate policies because they have exhausted all other

options. The Fed's arsenal seems better equipped, and they appear to be far away from showing signs of desperation.

Second, there is a saying that pioneers end up with arrows in their backs. Japan and Europe are using experimental policies, and their lack of efficacy to date could be a lesson to the rest of the world. Fed Chairman Jerome Powell has even pushed back the idea of going negative on more than one occasion (6).

But that's a *policy* decision. Whether or not markets send rates negative again is another question – one that is very tough to answer. If it were to happen again, just remember that markets are comprised of millions of transactions and participants working together to find the "right price." That is very different than a small group of self-interested politicians.

That being said, it does appear that rates will remain low for the foreseeable future, which is both good and bad. Money should continue to remain relatively cheap, which is timely considering we are about to issue trillions in debt to pay for all this stimulus. But it could also force retirees that rely on investment income to rethink their strategy.

The bottom line is that negative interest rates can be a function of both markets and policy. These are two different forces, so don't expect to get paid by a bank to buy a home anytime soon.

Sincerely,

Mike Sorrentino, CFA
Chief Investment Officer

Sources

1
http://cphpost.dk/news/business/business-round-uplowest-mortgage-rates-ever-seen-in-denmark.html

2
https://www.bloomberg.com/markets/ratesbonds/government-bonds/germany

3 https://www.cnbc.com/2020/03/25/negative-rates-cometo-the-us-1-month-and-3-month-treasury-bill-yields-arenow-negative.html

4
https://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_3.en.html

5 https://www.marketwatch.com/story/president-trump-sayshe-could-get-used-to-negative-interest-rates-why-youshouldnt-wish-for-that-to-happen-2020-01-22

6 https://www.bloomberg.com/news/articles/2020-05-07/negative-u-s-policy-rate-seen-by-early-2021-in-futures-market

Disclosures

Fleming Financial Services, Inc. is a Licensed Investment Advisor registered with the State of Arizona. This communication is not intended as an offer or solicitation to buy, hold or sell any financial instrument or investment advisory services. Securities investing involves risk, including the potential for loss of principal. There is no guarantee that any investment plan or strategy will be successful. The foregoing content reflects the opinions of Fleming Financial Services, Inc and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that the statements, opinions or forecasts provided herein will prove to be correct. Past performance may not be indicative of future results. Indices are not available for direct investment. Any investor who attempts to mimic the performance of an index would incur fees and expenses which would reduce returns.

Please contact us at (480) 632-8770 if there is any change in your financial situation, needs, goals or objectives, or if you wish to initiate any restrictions on the management of the account or modify existing restrictions. Please notify us if you do not receive statements from your Custodian on at least a quarterly basis. Our current disclosure brochure, Form ADV Part 2, is available for your review upon request. This disclosure brochure, or a summary of material changes made, is also provided to our clients on an annual basis.