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THE NEGATIVE RATES EXPERIMENT

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KEY TAKEAWAYS

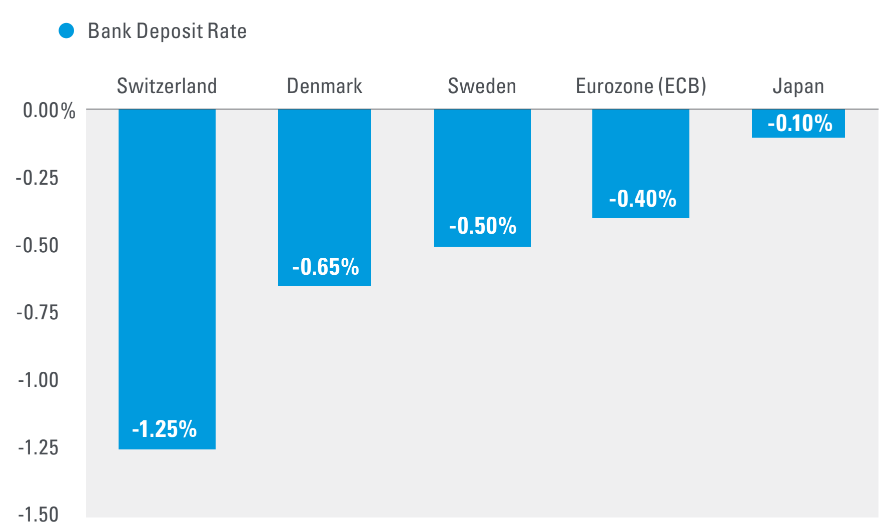
Negative interest rate policies have had profound implications for bond investors thus far, but limited benefits for the economies intended to gain from them.

The persistence of negative rates globally may keep demand for U.S. bonds elevated, limit any potential rise in interest rates, and keep bonds expensive for investors.

Negative interest rates are likely to persist as two central banks reiterated their commitment and a third, the Bank of Japan (BOJ), could do the same this week. Sweden's central bank maintained a -0.5% benchmark short-term interest rate and a -1.25% bank deposit rate but boosted its bond purchase program, and the European Central Bank (ECB) took a market-friendly turn as well by announcing easier than expected qualifying terms for corporate bond purchases.

Negative interest rate policies have had profound implications for bond investors thus far, but limited benefits for the economies intended to gain from them. Over the past two-and-a-half years, five countries have initiated the negative rates experiment, with Japan the most recent after cutting rates into negative territory in January 2016 [Figure 1]. By comparison, the Federal Reserve (Fed) pays a +0.5% deposit rate to banks who park excess cash at the Fed.

1 FIVE CENTRAL BANKS CHARGE NEGATIVE INTEREST RATES TO BANKS



Source: LPL Research, Bloomberg 04/25/16

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> Based on a limited history, negative interest rate policies have yet to show any meaningful positive impact, and at the same time have created unintended consequences and risks from global financial markets.

WHY NEGATIVE RATES?

Increasing bank lending is one of the main goals of charging banks negative interest rates to keep their excess cash parked at a country's central bank. The negative rate is intended to motivate banks to lend out funds in an effort to boost economic growth. A secondary, but less publicized, motive is to weaken a domestic currency. The ECB cut bank lending rates into negative territory in mid-2014, less than two months after the euro flirted with 1.40 versus the U.S. dollar, at that time a three-year high. A weaker currency can not only boost a country's exports but may also boost inflation — another goal of central bankers in countries facing deflationary threats.

IS IT WORKING?

Although the jury is still out on the ultimate effectiveness of negative interest rates, early results are questionable. Measured by bank lending to the private sector and inflation, early results are slightly disappointing for the ECB and the BOJ. The ECB's many policy tools — including bond purchases, targeted lending programs, and negative interest rates — are having a positive impact as Euro Area lending to both individuals and non-financial corporations has improved. Despite the improvement, results are still lackluster overall, with lending to individuals up 2.1% annualized and lending to institutions flat at 0% (i.e., stopped decelerating), both annualized through the end of February 2016. This helps explain why the ECB took bold action in March 2016 by cutting rates further into negative territory and boosting its bond buying program.

Inflation readings also show that negative rates are not having the intended effect. Annualized inflation is still hovering near zero in both Japan and Europe, where it has been since the middle of 2015, suggesting that demand remains weak, a problem that negative rates may not be entirely capable of fixing. Deflation may have been averted but inflation has yet to materialize despite aggressive action from central banks.

When the BOJ ushered in negative interest rates in late January 2016, market reaction was decidedly negative. A loss of confidence in central banks was partly to blame for market volatility early in 2016. Rate cuts further into negative territory could erode investor confidence without some signs current policy is working.

OTHER CONSEQUENCES

Instituting negative interest rates policy has had knock-on effects for investors. Keep in mind that the vast majority of banks (in areas where negative deposit rates exist) do not impose negative interest rates on consumer deposits. In some cases, banks look to recoup negative rates by charging higher fees elsewhere or passing them along to institutional clients. Still, the policies have impacted financial markets in a few ways, including:

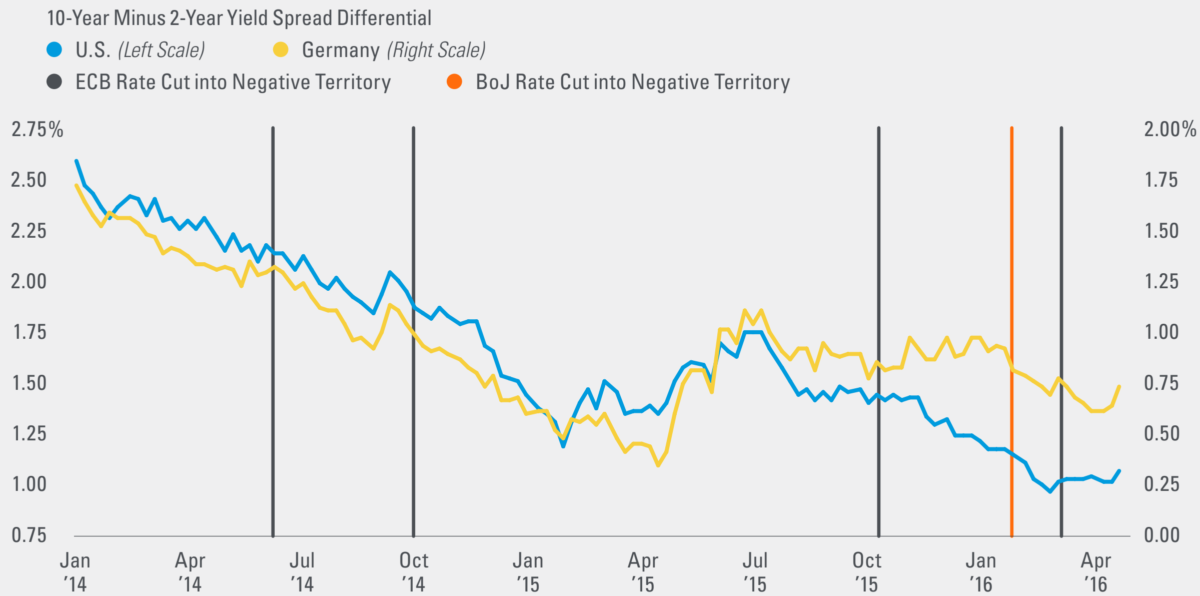
- **Lower bond yields.** By taking overnight borrowing rates into negative territory, central banks have pushed short-term bond yields into negative territory, forcing investors to extend maturity to obtain higher yields. In response, intermediate- and long-term bond yields have also declined, leading to "flatter" yield curves [Figure 2]. Although this may penalize savers, it is a desired result from a central bank perspective as its lowers the cost of borrowing for many. More than $7 trillion worth of government bonds trade with negative yields, out of a global bond market of nearly $100 trillion.*

- **A stronger U.S. dollar.** Short-term interest rate differentials are a key driver of currency valuations. By lowering benchmark interest rates into negative territory, the U.S. dollar strengthened against major currencies such as the euro and yen from mid-2014 through the end of 2015. The U.S. dollar weakened slightly during the first quarter of 2016, but it remains elevated versus major currencies and has created economic challenges not only for U.S. manufacturing but also for international economies.
- **Increased demand for U.S. bonds.** Negative interest rates in Europe, coupled with the ECB's decision to further cut interest rates in March 2016 have been one factor behind outflows from European bond mutual funds, according to Investment Company Institute data. Assets under management in international bond funds have witnessed an approximate 30% decline since the start of the year through the end of March 2016. U.S. core bonds, on the other hand, have witnessed a 25% gain in assets—and this does not include other U.S. bond categories such as municipal, investment-grade corporate, and high-yield dedicated bond funds that have also witnessed respectable gains in assets so far in 2016. Strong demand for U.S. bonds has helped keep U.S. interest rates low despite prospects for Fed rate hikes in 2016 and beyond.

Concerns over global economic growth also played a role in the factors above, but these drivers are all intertwined.

*Bank of International Settlements & Bloomberg data 04/25/16.

2 U.S. & GERMAN YIELD CURVES HAVE MORE OFTEN FLATTENED FOLLOWING RATE CUTS INTO NEGATIVE TERRITORY



Source: LPL Research, Bloomberg 04/25/16

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

Past performance is no guarantee of future results.

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RISKS

The above consequences are also partly in response to some of the risks associated with negative interest rates, including:

- **Bank risks.** Banks function as the grease that lubricates the wheels of the global economy. Negative interest rates can harm a bank's profits and potentially impair its creditworthiness. Bank funding fears, although calm now, contributed to stock market weakness and Treasury strength in early 2016.
- **A bleak outlook.** Negative interest rates reflect weak economic growth and a potentially deflationary environment in the host country. Therefore, negative interest rates imply a poor investment outlook and may hinder investment necessary to engineer improvement in the local economy.

CONCLUSION

Based on a limited history, negative interest rate policies have yet to show any meaningful positive impact, and at the same time have created unintended consequences and risks from global financial markets. Thankfully, Fed Chair Janet Yellen has pushed back on the idea of negative rates in the U.S. In her press conference following the March 2016 Fed policy meeting, Yellen stated negative rates are not being considered and labeled the experience in other countries as "mixed" with both positive and negative impacts.

This week's Fed policy meeting will not include a press conference or economic projections, only the brief policy statement, and is unlikely to be a market mover. (See our recent *Weekly Economic Commentary* for more on this week's Fed meeting.) The BOJ also meets this week but is not expected to cut rates; however, according to Bloomberg consensus, additional stimulus, which could involve another rate cut, is expected by the end of June 2016. The persistence of negative rates around the globe may keep demand for U.S. bonds elevated, limit any potential rise in interest rates, and keep bonds expensive for investors. ■

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