Financial Virus: Will Negative Rates Spread to America?

"You OK?" -- Clay Easton, from the film *Less Than Zero* (1987)

By James P. Freeman

Last fall, as markets were reaching Everest heights, President Donald Trump began calling for below-zero interest rates in the United States, a phenomenon that has beset many European countries and Japan, to little positive effect. While appealing on the surface, supporters of such an interest rate environment should temper their enthusiasm and take caution: Be careful what you ask for.

On September 11, 2019, President Trump tweeted, "The Federal Reserve should get our interest rates down to ZERO, or less, and we should then start to refinance our debt." The president renewed such calls last November, during a speech at the Economic Club of New York. He claimed that comparatively higher interest rates in the United States "puts us at a competitive disadvantage to other countries." And, more recently, at the World Economic Forum in Davos, Switzerland in January, he echoed similar sentiments. Other nations, Trump said, "get paid to borrow money, something I could get used to very quickly. Love that."

Negative interest rates are not normal, and they have never occurred in America.

So, what exactly is going on here?

Typically, in any given lending arrangement, the borrower pays back principal and compensates the lender with interest for use of the money. A loan with a longer duration usually fetches higher rates; a loan with a shorter duration usually fetches lower rates.

But in some sectors of the global credit markets something strange has happened -- the underlying mechanics of that understandable and long-held lending model have changed. It is the borrower who is compensated, not the lender. In other words, a lender who lent $100 with a 3 percent interest rate received a $103 return. Now, that same lender may be receiving -- theoretically, in a market with negative rates -- only $97, not $103.

For nearly forty years interest rates in the United States and around the world have dropped dramatically (in 1980 the U.S. Prime Rate peaked at 21.50 percent; today it stands at 4.25 percent, according to "FRED," the economic research arm of the Federal Reserve Bank of St. Louis). Both consumers and corporations have been the beneficiaries of the low cost of borrowing money. It fueled the greatest period of prosperity in America history. Causally and conversely, however, it acted as the catalyst for massive levels of borrowing, as the government for decades has spent more than it received. In addition, government -- at all public-sector levels, federal, state and local -- likewise has been a beneficiary, financing massive levels of debt at low cost. But the federal government is different.

The federal government is granted the authority to control both monetary policy (interest rates and money supply) as well as fiscal policy (taxes and spending). Created in 1913, the Federal Reserve (the "Fed") is the country's quasi-independent central bank, and responsible for supervising the nation's banks, overseeing the stability of the financial system, conducting monetary policy and, perhaps most importantly, maintaining the dollar as a store of value. On the other hand, fiscal policy is determined mostly by Congress with input from the president. For decades, both the legislative and executive branches have agreed to increase the size and scope of government without paying for it (deficits and debts). And tax rates have trended downwards for decades too (most recently with the Tax Cuts and Jobs Act of 2017).

Ostensibly economic tools, fiscal and monetary policies are nevertheless dictated by political actors, and prone to political motivations. Nevertheless, such polices, when effected sensibly and even harmoniously, can promote economic growth and stability. Of course, global disruptions and market imbalances coupled with bad decisions have, at times, wrought havoc. Such events are mostly garden-variety downturns while others are more severe, like The Great Depression of 1929 and The Great Recession of 2009.

Policymakers took extraordinary measures in 2009 to stave off a total collapse of the financial system and a real depression. Of particular import was unprecedented monetary policy. The Fed brought short term rates close to zero and greatly expanded the money supply by injecting trillions of dollars into the financial system. As a result, markets recovered, and the U.S. economy went on to the greatest bull run in history. Notably, though, the Fed largely kept these extraordinary polices intact, even as the stock market rose to record highs and unemployment fell to near-record lows.

Therein lie the problems.

Some market observers have opined that the market rally in 2019 and early 2020 was a perversion precisely because of constant Fed intervention. They argue that this was a Fed-induced asset bubble. These same observers cite the central bank's maintenance of artificially low interest rates (three reductions in the Federal Funds Rate in 2019), flooding the market with trillions of dollars in cash or liquidity (by buying U.S. Treasury securities, known as Quantitative Easing, "QE"), and what is called "Repo" (supporting overnight lending among big banks, a form of money flow or plumbing for Wall Street) -- all during a roaring market and booming economy. It was reasonable to ask, observers wondered, why the Fed was doing all this during good times. Such actions were historically reserved only for extreme market disruptions that threatened the American economy.

The Fed was not alone in its actions.

Most European countries did not see economic expansion of the size of the American one in the 2010s. Their recovery was much more muted. As a result, in order to spur economic activity, European interest rates were set even below American rates. In June of 2014, a stunning event occurred. The European Central Bank (ECB) introduced negative rates by lowering its deposit rate to minus 0.1 percent to stimulate the economy. It proved to be overall futile. Eurozone countries (and Japan) never fully recovered and economic growth remained anemic at best.

By 2019, 14 countries had sovereign debt with negative yield as markets and governments drove down rates. Today, the global pool of such securities is about $12 trillion, and includes some corporate debt. Last September, the ECB cut its already negative deposit rate to minus 0.5 percent. In fact, 56 central banks cut rates 129 times last year, according to data from CBRates, a central bank tracking service. Some market participants have questioned the efficacy of such monetary policy, given little to no economic growth as a result. And policy makers are perhaps finally realizing that monetary policy alone has its limits.

There's a growing negative perception of negative rates reflecting the negative impact.

Still, there are other reasons why yields have plunged. Think of the basic supply-demand equation. While governments have been issuing an enormous supply of low-yielding debt there has also been an enormous demand for government securities. Most government bonds are known to be to a safe harbor for investors in times of turbulence, as they can be used to hedge against all sorts of risk (market, political, etc.). Of course, the safest of safe harbors has been and continues to be the United States.

In times of crisis, global investors have always sought protection by buying U.S. Treasury securities, as these securities offered a reasonable rate of return and penultimate safety. But even in times of relative tranquility these securities have been attractive for domestic investors, particularly pension plans, senior citizens, and financial institutions. Over time and into early 2020 a convergence of market dynamics -- heavy demand, along

with heavy Fed buying and issuing of large quantities of treasuries (supply) -- have brought yields down substantially and have made government securities very expensive. Even before the novel Coronavirus called COVID-19.

The long-term average yield of the U.S. 10-Year Treasury Note, the American bell-weather security, is 4.49 percent. A year ago, the 10-Year yielded 2.64 percent. It has fallen steadily since (ycharts.com and FRED). Now, with fears of the global pandemic palpable, the yield recently hit an intra-day record low of 0.31 percent.

The Coronavirus has, if anything, exposed the fragility of current markets. In classic crisis mode, investors have been fleeing global stock markets and stampeding the U.S. government bond market. Yields across the spectrum of treasury maturities (3-month to 30-year) have set record lows, driven by record demand and Fed intervention with barrels of liquidity.

Just over a week into the global stock sell off, on March 3, the Fed cut the Federal Funds Rate by half of a percentage point (for a targeted range of 1.0 percent to 1.25 percent) in response to the threat posed to the economy by the Coronavirus. This emergency action was the first time that the Fed cut rates for a public health challenge, not a financial one. And in another emergency move on Sunday, March 15, following two weeks of market carnage, the central bank set this rate to effectively zero as markets continue to roil -- matching similar action taken during the financial crisis in 2009, along with more massive QE. It is now entirely possible that the Fed Funds Rate may be set in a negative range and U.S. Treasury yields could turn negative for the first time as well. Even despite the slow lurch to negative yield, on a conference call on the same day of the latest action, Fed Chairman Jerome Powell dismissed the likelihood of using such a tool.

“We do not see negative policy rates as likely to be an appropriate policy response here in the United States,” Powell told reporters.

Well.

As the robot in *Lost in Space* warned: “Danger Will Robinson! Danger!”

No one in America quite knows how to navigate the unchartered frontier of negative yields. There is no play book or history book. Or Book of Revelation.

Some of the consequences of rates marching to zero are already apparent. One is that the government via the Fed (monetary policy) has incentivized undue risk taking. Lower government bond yields have forced otherwise conservative investors to chase higher returns in stocks and corporate bonds, creating unmanageable asset bubbles. (Will Treasuries in 2020 become the tulips of 1637?)

Congress and the president (fiscal policy) have been incentivized to borrow even more money (under the absurd assertion that the country can “grow” its way out of debt; during

the bull run debt grew significantly). Remember, candidate Trump in 2016 promised to not only reduce the national debt, but actually eliminate it. At over $23 trillion today (CNBC reported last February), the debt has grown by $2 trillion under President Trump.

Arguably, disastrous monetary policy has financed even more dreadful fiscal policy.

America used to borrow *for* the future. We now borrow *from* the future. Record low yields have fueled record amounts of debt. One unintended consequence of this predicament is that it unwittingly gives legitimacy to the absolutely ludicrous idea of "Modern Monetary Theory" (MMT). Properly understood, the theory allows that government can and should print as much money as it needs to spend because it can not become insolvent, unless there is a political reason to do so. MMT treats debt simply as money the government has placed into the economy and did not tax back. Furthermore, and rather dangerously, MMT advocates believe there are no consequences to staggering levels of debt. They simply ignore abundant evidence to the contrary (history is littered with examples of sovereign default).

There are more tangible and immediate consequences to consider as well. In a simpler time, the bond market was known as the "fixed income" market. For a good reason. Most bonds paid a fixed amount of interest, usually every six months. A steady stream of interest provided investors with income. Negative yield penalizes savers who have relied upon Treasury securities for safety and some rate of return. Why would seniors want to pay borrowers for the use of their money?

Negative yield also affects banks and other financial institutions like insurance companies. These entities rely upon yield to fund operations. Annuities, for instance, are financial contracts whose rates of return are dependent on market instruments, like fixed income securities. And pension plans assume a certain future return for actuarial purposes.

JPMorganChase Chairman and CEO Jaime Dimon has expressed concern. At the same Davos event the president spoke at in January, the head of America's biggest bank expressed "trepidation" about "negative interest rates." He added that, "It's kind of one of the great experiments of all time, and we still don't know what the ultimate outcome is." Last October he told a group attending the Institute of International Finance he would "not buy debt at below zero." And with a sense of gravitas, Dimon concluded, "There is something irrational about it."

If the government started issuing negative-yielding debt banks would need "to find other ways to replace the income they need to generate from their deposits at the Fed," believes Michael Hennessy, chief executive of Harbor Crest Wealth Advisors. One way to do that would be to raise fees on consumers. Another option -- a nuclear option? -- would be for banks to offer negative deposit rates to the average saver and consumer. That outcome is nearly unimaginable.

Then there is the tax code. Writing for the Wall Street Journal last November, Paul H. Kupiec believes the tax code can't handle negative rates. "Should negative interest rates one day become reality," he writes, "the tax code will need to be amended." Kupiec also says that negative rates would effectively be a "new federal tax levied by the Fed on banks." Negative interest rates are treated as a consumer expense, and right now current law doesn't allow such an expense to be deducted when calculating taxable income.

Finally, there is the general perception that negative yield carries: People feel poorer. They would be drained of income. They would not be paid for the use of their money. On the contrary, they may be paying people for the use of their money. Marked deflation is just as bad as marked inflation. Besides, such a precipitous drop in treasury yields and the corresponding inversion of the yield curve (when yields in longer maturities are lower than yields in shorter maturities) portend recession. Recessions are normal and natural. Yet, with twisted irony, the federal government -- with all its extravagant intervention -- has exacerbated not only the likelihood of a recession but perhaps its severity too.

Joseph Brusuelas, RSM chief economist and a member of The Wall Street Journal's forecasting panel, strikes a cautionary tone. He reasons: "Because the U.S. economy is so highly 'financialized' [meaning it is reliant on big banks to provide liquidity], negative rates wouldn't yield a good outcome in the long-term."

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