In the Bizarro World of Negative Interest Rates, Saving Will Cost You

Strategies
By JEFF SOMMER MARCH 5, 2016

Until a few years ago, that’s the kind of offer a gangster might have made. In the world as we’ve known it, if you lend someone your cash you expect to receive something — typically, interest — in return.

But something radically different is afoot today. It’s called negative interest — and it is an inversion of the traditional relationship between lenders and borrowers.

“It’s all upside down,” said Kathy A. Jones, chief fixed-income strategist at Charles Schwab. “Negative interest is hard to even think about. Our whole financial system is built the other way, on positive interest rates. This is mind-boggling.”

Negative rates have been spreading through important sectors of high finance in Europe and Asia. They are not being offered in a systematic way to retail investors, as far as I know, but Bloomberg found last month that more than $1.1 trillion worth of German bonds and about $4.5 trillion in Japanese government debt carried negative interest, and more than $7 trillion in bonds over all had negative yields. Central banks, which have helped engineer the arrival of negative interest rates, are buying some of these bonds themselves, but private investors are doing so, too, accepting probable losses.
The central banks have been going negative to stimulate their relatively weak regional economies and raise inflation levels, which have been perilously low. They hope negative rates will accomplish these goals in three ways. First, the central banks want commercial banks to lend more money at very low interest rates. Second, they want commercial bank customers to borrow more, spend more and save less.

There is a third reason, which central bankers rarely enunciate in public: Negative interest rates tend to drive down the value of a country’s currency, making its exports cheaper and more competitive in global markets.

That may be very good for a single country but when several of them do it and a currency war erupts, there is a real danger of uncontrolled economic shock and concomitant pain around the world. Preventing such a war was on the agenda of the Group of 20 finance ministers and central bankers meeting in Shanghai last week, but no significant agreement was reached. The dollar is likely to continue to strengthen, and the possibility of future conflict over interest and currency exchange rates is a risk for people who aren’t directly exposed to negative rates.

In the United States, Federal Reserve officials say they might use negative interest rates in a future crisis, but they don’t expect to install them here anytime soon. Nonetheless, global markets are tightly linked, and negative rates in Europe and Asia are already influencing financial markets here, in that way affecting the lives of ordinary people.

The effects have been mixed: Negative rates on foreign debt have helped keep a wide range of interest rates in the United States unusually low, which translates into good deals for borrowers and bad for ones for lenders, including major banks, whose profit margins have been compressed. For older people trying to live on their bond investments, low rates result in paltry income and painful choices.

The unusual conditions defined by negative interest rates also complicate matters for the Federal Reserve, which has begun to raise short-term rates in the United States, only to see longer-term rates decline. That unexpected development is occurring partly because below-zero rates in European and Japanese bond markets have created greater demand for American bonds, raising their prices and driving down yields, which move in an opposite direction. Negative rates have not been common for very long and their consequences aren’t entirely understood.
Still, grasping the basics of how negative rates work and how they may be affecting the United States is important for anyone with money in the markets.

Consider that if you deposit your savings with a bank that has negative interest rates, the longer the bank holds your money, the less you will have in your account. The flip side of this is marvelous: The longer it takes to repay a negative-interest-rate mortgage, the less you owe, even if you pay nothing. In short, negative rates can make saving money seem foolish, while borrowing can become epically attractive. (The European banks generally have not deliberately passed negative rates on to retail customers, but negative-interest-rate mortgages cropped up temporarily in Denmark for some people lucky enough to have had adjustable rate mortgages.)

Negative rates appeared during the global financial crisis in 2008, when yields on some United States Treasury bills fell below zero for brief periods. That happened because so many panicky people wanted to buy Treasuries that their prices soared and their yields dropped into negative territory. In essence, investors were willing to lose a small amount of principal in exchange for the safety. Those negative interest rates were a sign that the financial world was in trouble.

Today’s negative rates are not a short-term market anomaly. To the contrary, central banks in Europe and Asia have made negative interest rates part of their official tool kit. The European Central Bank; the central banks of Switzerland, Sweden and Denmark; and, last month, the Japanese central bank have all deliberately set at least some short-term rates below zero — effectively penalizing commercial banks for depositing funds with them, and giving them a strong incentive to move their money elsewhere.

Negative rates abroad have caused another problem for the United States, and, perhaps, created an opportunity.

They make it difficult to determine why interest rates in the United States are so low — much lower than would be expected if the American economy were truly healed from the last recession. Those low rates are a bit of a puzzle given the Fed’s stated intention of continuing to raise short-term rates.

But interest rates here make much more sense when compared with negative rates in European and Japanese bonds. Bond markets are global, and those negative rates abroad are among the factors depressing interest rates in the United States, Scott Minerd, global chief investment officer for Guggenheim Partners, said in a
recent commentary. Further declines in German rates are likely to lead to declines in American rates as well, he said, even if the Fed intends to push rates higher.

Jim Paulsen, chief investment strategist for Wells Capital Management, said in an interview that while these risks were real, barring an unforeseen shock, it was probable that the American economy would continue to strengthen. And if that happens, current American interest rates — particularly those for inflation-indexed bonds called TIPS — have been set low. TIPS may be a good investment now because their pricing assumes that the inflation rate will be only about 1.4 percent a year for the next five years — and, if an economic recovery is in place, inflation is bound to move higher than that, giving investors a tidy profit.

A riskier bet could be made with investments in the domestic stock market, which would be likely to rebound significantly if it turned out that despite negative rates abroad, the economy was robust in the United States, he said. “We would see a rally in a range of risk assets,” he said. “There would be some real money to be made.” The possibility of significant losses was high, too, he said.

Conservative, risk-averse investors find themselves in a hard place. As long as interest rates remain negative for the bonds of major countries like Germany and Japan, it will be difficult for American bond yields to rise much. The safest investments, like 10-year Treasury notes, are providing extraordinarily low yields — only about 1.9 percent. Junk bonds, with higher yields, are risky when the economy is under stress, Ms. Jones of Schwab says. “We’re pointing our clients toward a middle ground — investment-grade corporate bonds,” she said. They provide a modicum of safety and somewhat better yields than government bonds do.

That’s not a happy situation. But in some respects it is an upside-down world. Sometimes the best you can do is hold on to your money.