Negative Interest Rates – Has Monetary Policy Gone Too Far?

Over the last several years, the Bank of Japan (BoJ) has made a number of audacious moves to reinvigorate the island nation's economy, including zero short term rates and a quantitative easing program which is larger in size, when compared to gross domestic product (GDP), than the programs undertaken by either the U.S. Federal Reserve (Fed) or the European Central Bank (ECB). The BoJ's most recent move came at the end of January, surprising investors with a negative nominal interest rate. It is a rare move, and we wanted to provide our thoughts and our view on the likelihood that it could spread to other markets.

In plain English, negative nominal interest means that borrowers owe less on a loan than the amount originally borrowed. This arrangement is an unnatural construct, which should not exist in a normally functioning economy. Simply put, if one could borrow $10 and owe back $9 to the lender, it would not be long before the lender either runs out of money, or what's more likely, stops lending. Put another way, if an individual deposited money in a savings account and was charged a fee to maintain the account instead of receiving interest, that individual would likely seek out other options to save, or ideally invest, the money.

This situation is exactly the one on which Japanese central bankers are betting. In this case, they are looking to incent Japanese commercial banks to take a risk and offer more profitable business and mortgage loans at a positive rate, instead of stashing available money at the central bank, where a negative rate means they are locking in a loss. Effectively, Japan is communicating to its banks that, going forward, they must lend more money.

In turn, making more loans available tends to spur economic activity. It also increases the velocity of money—the number of times money changes hands over a period of time—which may lower deflationary pressures on an economy. As reminder to investors, deflation is bad to economic activity. It discourages spending and punishes savers whose assets decline in value, which is why central bankers take all possible measures to avoid deflation.

Effective February 16, the BoJ's negative interest rate policy does not affect all banks deposits, and it only applies to bank reserve balances in excess of regulatory minimums. We expect the immediate impact to be minimal, but it may encourage banks to lend and companies to spend, which will help the Japanese economy. It may also allow people to move money out of Japan, which should cause the Yen to depreciate further. Both these moves may invite inflation into Japan's economy, which may be positive to Japanese equity markets if successful.

From a broader perspective, negative interest rate policy has been compared by Rick Rieder, strategist at BlackRock, to being served one too many ice cream sundaes. Others have called it "policy overdose" or otherwise likened it to going too far. The economic view is that when rates are near zero, monetary policy becomes less impactful as a means to spur growth. When rates are negative for a prolonged period, their effect may also be contractionary—lending declines and consumers tend to save and hold cash rather than spend. In our view, this move is a limited policy tool, which may be used only temporarily and when there are substantial deflation risks. This policy has been used briefly by smaller central banks in Europe and in 2014 by the ECB itself, but it is unlikely that this will become the norm.

In our opinion, the negative rate move by the Japanese Central Bank, while newsworthy, is largely a local phenomenon. It may help ignite a burst of lending, resulting in a temporary increase in Japanese equity prices, and will likely lower the Yen over the near term. However, the move is unlikely to spread to other nations and for broadly-diversified international portfolios its effect may be muted.

Domestically, it is unlikely the U.S. will follow suit, but it may make it more difficult for the Fed to proceed with their plan of returning to a more normal interest rate environment. If the Fed were to raise rates at this point, global money desperately seeking higher yield will fly into the dollar. The greenback would become even stronger against the Yen, as well as the Euro and other global currencies, and disadvantage U.S. export trade.

Because so much uncertainty exists today, we continue to expect market volatility to remain elevated as investors balance the aforementioned concerns with positives that still exist. These positives include low global interest rates, improved manufacturing data, and accommodative central banks. We therefore recommend maintaining allocations to equities based on long-term investment objectives, staying near benchmark on stocks, bonds and cash.

We continue to favor domestic equities over international, especially with a bias toward growth over value. As always, we recommend staying fully diversified to limit over concentrations in any one asset class. Lastly, we believe it prudent to retain an allocation to alternative investments that have low correlations to traditional investments.

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