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The Great Negative Rate Debate

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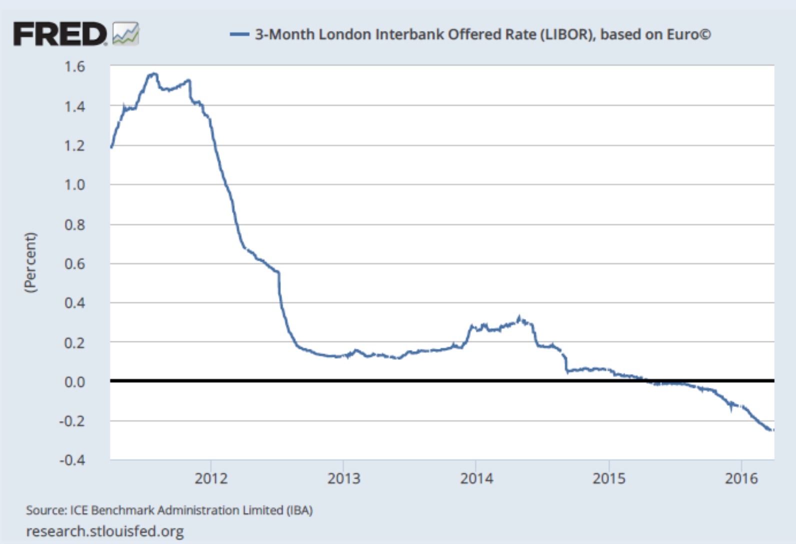
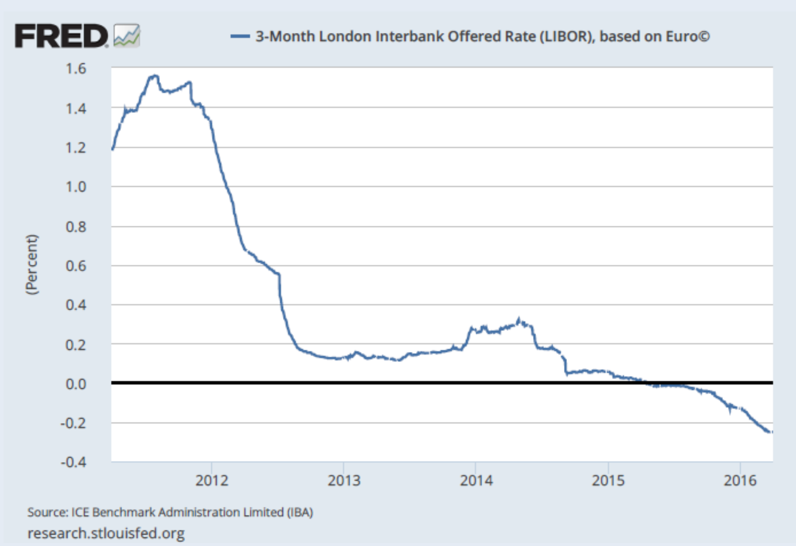
May, 2016— With all the news media focused on the election circus, very few seconds are dedicated to the anomaly that has now exposed itself upon foreign shores: negative interest rates.

You read that right. Negative interest rates. Just when you thought the world couldn't get any weirder, it has.

I can understand negative temperatures or negative press—but negative interest rates? That's a little like negative rain, or negative time. Nonetheless, they have arrived.





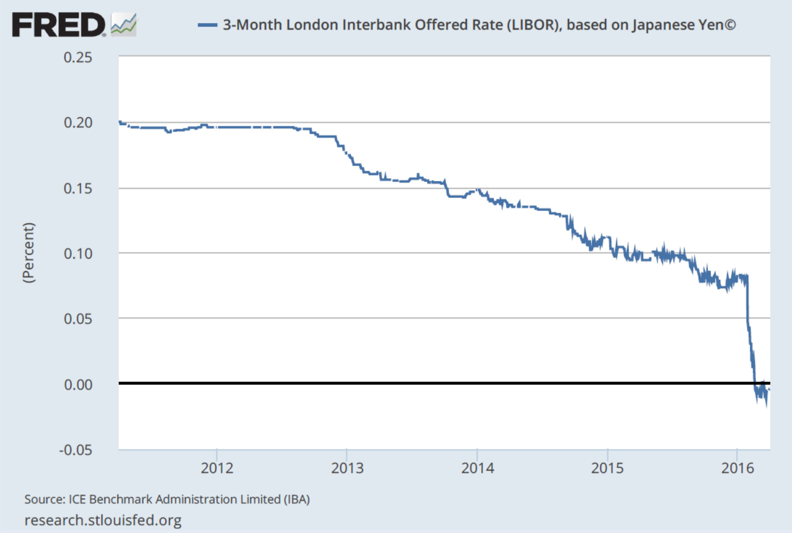
Sweden's central bank began the "experiment" in July 2009 in an effort to rejuvenate their economy after the 2008 crash. One might say that the Swedes invented it.[1]

Of course, then, it didn't really make headline news because Sweden doesn't impact the world economy too terribly much.

But since then, other desperate economies have started to use the stratagem: Large enough economies to shake the world markets.

The first chart shows the Swiss banks going negative at the end of 2014 to -.8%.

The second chart shows the European banks going negative in the middle of last year, to about -.25%.



Not to be left to the European theater, the Japanese have imported negative rates to the Land of the Rising Sun.

Here you can see Japan's rate going negative in the first quarter of this year, down to just a fraction of a percent negative.

So now, out of the world's four largest economies, the the European Union, the U.S., China, and Japan, two of them employ negative rates—Japan and the E.U. In all, there are currently nine countries employing negative rates.[2]

You know there is something very wrong with an economy when interest rates go negative. Can't you just intuitively *feel* that? Who in their right mind would deposit money at a bank, and pay the bank interest?

The reason given by the European Central Bank for negative interest rates is "to further ease the already accommodative monetary policy stance to fight the growing threat of deflation amid downward pressures to inflation expectations."[3]

In short, they want more inflation.

The lesson—like most economic lessons (as my econ professor Dr. Shropshire drilled into my psyche)—goes back to simple supply and demand.

Inflation comes from an increase in the money supply. The more money out in the economy, the less each unit of money is worth in terms of what you can buy. We can clearly see this in action at the grocery store.

In utilizing negative rates, the central banks are trying to force people out of cash. They want you to spend it—which helps stock prices—and they want you to invest it, which also drives up stock prices.

But most of all they want you to borrow it—because in a fractional-reserve banking system such as ours—borrowing actually "creates" money, and remember more money means inflation.

But there's been a problem with their scheme. No matter how much money they print, no matter how low they drop rates (zero used to be considered the bottom), no matter how low they set the bank reserves ratio, people are just not borrowing.

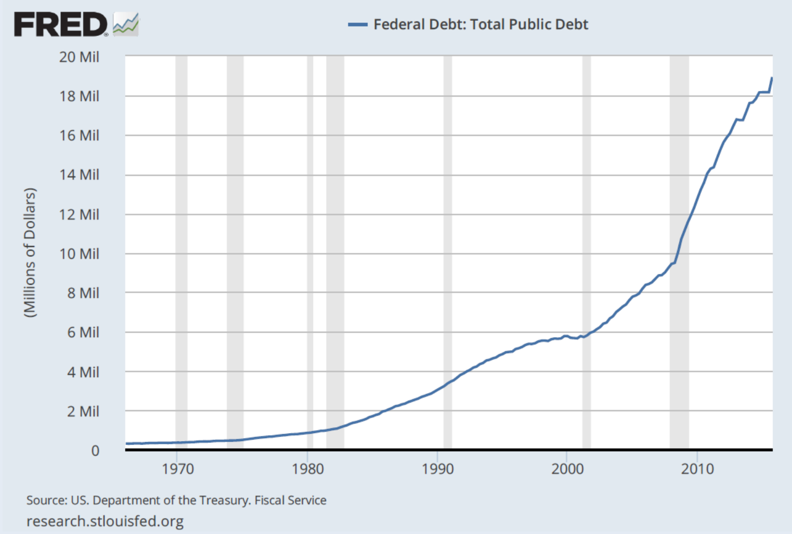
This is supply side economics. George Bush Sr. called it "VooDoo Economics," which is a term I find appropriate. Just because you have a lot of something doesn't mean people will want it. And yes people always want money, but what we have seen is that they just don't want the associated debt.

But governments don't mind the debt. They love debt. Our whole world is run on debt. Already we have seen where Puerto Rico is defaulting on its debt. On May 2, Puerto Rico failed to make a $400 million principal payment. This is likely to be the first of many as more that $2 billion is due from Puerto Rico over the summer.[4] Ironically, "Puerto Rico" means "rich port."

These charts represent *our* debt.

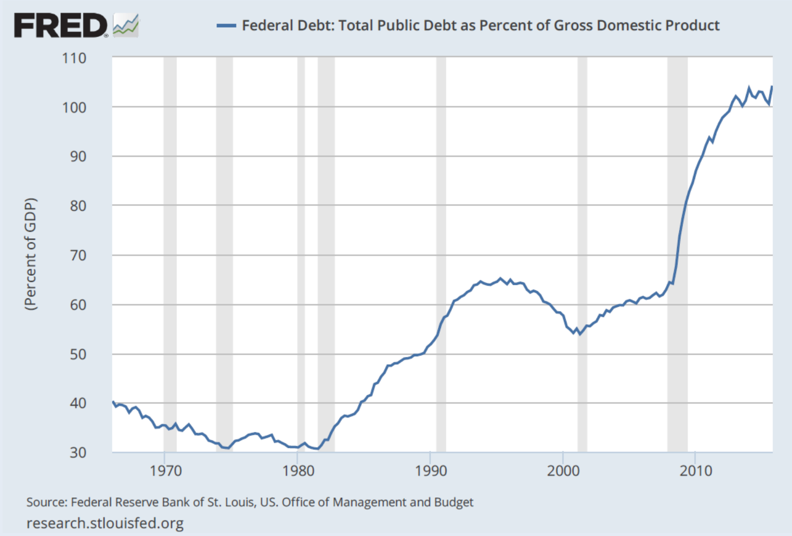
The first chart to the right is our total public debt in terms of millions of dollars. In 1970, you can see it was practically nothing.

By 9/11, we were steady at around $6 trillion. Today, our total debt is over a whopping $19 trillion. Do you think we will *ever* pay that off?



What's worse, not only can we not pay it off, we can't even slow it down. Why is no one talking about this? This is the *real* danger to America.

Here's another way to look at debt—which is as a percentage of Gross Domestic Product. This is helpful when comparing economies. So, for example, at 9/11 we had debt of only 55% of our economy. Today it is over 100%. How high can we go?



Other economies fare worse. Greece, for instance, has a debt to GDP ratio of closer to 160%. Japan's debt to GDP ratio is over an astonishing 200%.[5]

It is in the interest of highly indebted countries (and people) to have inflation. In fact, the more inflation the better. Inflating money helps to drive down the real costs of debt. For example, a $1000 debt in 1920 was huge; today it's peanuts.

So what does all this mean?

That's the million dollar question. The rule of unintended consequences is surely to bite us in the end. Already, we have seen where investors have begun to withdraw their cash rather than pay the negative interest. This has induced some lawmakers in Europe to consider getting rid of cash money altogether.

> In early 2015, JP Morgan Chase forbade some customers from storing cash in safe deposit boxes. Swiss banks refused to allow pension funds to withdraw large amounts of cash from their accounts. Danish legislators proposed a law allowing shops to refuse to accept cash payments. Australia imposed a 0.05% tax on some bank deposits. And France cut the legal limit on cash payments from 3,000 Euros to 1,000 Euros.[6]

I foresee a day when cash as we know it will cease to exist. Everything you buy will be through electronic means, and every transaction subject to government scrutiny.

Whatever the consequences with the negative interest rate experiment, we just don't believe it can be good in the long run. This completely undermines savers, and forces conservative investors into alternative products that carry too much risk. Everything is fine until it isn't.

If nothing else, we now know that zero is not the bottom, so the Fed is watching Europe and now Japan with great interest. Perhaps they think they have another arrow in their quiver, to use when the market takes another 2008-style dive. I think you can bet on it.

So with low interest rates, money printing, and now negative rates, one would expect global stock markets to soar, but this has yet to occur. What are we to make of this?

History has shown that stimulus takes time. It could also be the law of diminishing returns. We've had so much global stimulus since 2008, perhaps more is just an exercise in futility. Indeed, with all the quantitative easing and interest rate manipulation, we should see price bubbles everywhere.

We look around for massive stock bubbles that might burst, and don't really find any. We continue to believe that stocks are not yet set for a major correction, and that we really need a new big fat juicy bubble before we can get set for a tremendous crash. Remember, it has always been in a rising rate environment that stocks have crashed and stock bubbles have burst.

The only bubble that seems apparent is in the bond market. Prices of bonds everywhere have rallied, especially higher quality bonds. A bond paying 0% is better than a bond paying -0.5%, so surely bonds paying 1% are going to be in great demand.

Over time, we might expect that negative rates will drive more money into investments and out of cash, which should buoy all boats. At some point these central banks will be looking to reverse their actions and start raising rates. When that occurs, we will be on notice to begin looking for bursting bubbles, not just in bonds, but in stocks and real estate as well.

[1] https://www.theguardian.com/business/2016/feb/18/negative-interest-rates-what-you-need-to-know
[2] http://www.forbes.com/negative-interest-rates-coming-soon-to-a-bank-near-you
[3] http://www.worldbank.org/Global-Economic-Prospects-June-2015-Negative-interest-rates
[4] http://www.wsj.com/articles/puerto-ricos-debt-crisis-turns-up-the-heat-on-congress
[5] research.stlouisfed.org
[6] https://blogs.cfainstitute.org/how-will-negative-interest-rates-change-the-rules-of-the-game

About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

About Magellan Planning Group

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- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm.

- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)

- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

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