Negative Interest Rates: The New Reality?

Negative interest rates in Japan and a number of European countries pose issues and concerns for investors and financial markets. Will the U.S. be next?

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Imagine a world where *you pay* interest to invest your money, and lenders *pay you* interest to take out a loan. Sounds crazy? In fact, this topsy-turvy situation is what is happening now in Denmark, Japan, Germany, France, and other European countries. Negative interest rates -- where investors agree to get paid back less than they've invested -- apply to a growing proportion of sovereign debt. Over $16 trillion in bonds are now yielding negative returns, representing about 30% of all the government debt outstanding in the developed world.[1] Until recently, negative rates applied only to short-term debt. But in August, Germany sold the first negative yielding 30-year bond issue, with an average yield of -0.11%. On the flip side, a bank in Denmark is now offering a 10-year fixed-rate mortgage at negative 0.5%.

How did this surreal situation come to pass? More importantly, is it likely to spread to American shores?

Uncertainty, Safety, and Stalled Economies

The foundations for negative rates were laid back in the wake of the financial crisis, when central banks worldwide radically dropped interest rates in an effort to reignite economic growth. But growth in much of the developed world -- excluding the U.S. -- has remained tepid, and rates have stayed low or trended down even further. Japan and many European countries have also had to contend with aging populations and shrinking labor forces due to low birth rates, putting further downward pressure on economic growth and interest rates.

More recently, volatility, uncertainty in financial markets, and the prospect of a global recession have increased investor angst to the point where many are willing to pay for the security of a "safe" asset -- one more likely to maintain its value in the event of an economic shock.

Is the U.S. Next?

Although the negative-rate bug has infected much of Europe and Japan, most economists do not foresee it spreading to the U.S. in the immediate future. By comparison, the U.S. economy is booming and its labor force is growing. Rates on U.S. Treasuries are still in positive territory, with current yields ranging from 1.39% to

1.96% for maturities between one and 30 years.[2] That said, rates are at or near all-time lows, and rates on many short-term Treasuries stand above long-term rates -- a so-called inverted yield curve. Historically, this situation has been a harbinger of recession. In fact, the yield curve has inverted before every U.S. recession since 1955. If a recession does come to pass, rates will likely turn further downward as the Federal Reserve attempts to stimulate growth. Whether rates would still stay positive in such a scenario is unknown. But for the time being, negative rates in the U.S. on a par with those in Europe appear unlikely.

Long-Term Concerns

Zero or negative rates, in themselves, are not an issue. "Zero has no meaning, beside being a certain level," notes former Federal Reserve Chairman Alan Greenspan. Lowering rates from, say, +1% to -1% is no different than decreasing them from +5% to +3%. It's still a 2 percentage point drop. But paying someone to take your money is counterintuitive and has a behavioral impact, potentially instigating harmful investor practices.

For instance, the prospect of negative rates is likely to drive investors into riskier assets, as they seek positive yields. And, if banks were to start passing negative rates onto retail depositors, the effect would be similar to inflation -- consumers might respond by consuming more and saving less.

There is also the fact that the whole business of banks and other financial institutions relies on positive interest rates. Widespread negative rates could wreak havoc with many institutions and necessitate a rethinking of their business models. Negative rates also impact currency rates, driving down the value of low-rate currencies. Perhaps the greatest concern is the uncertainty and unpredictability that negative rates inject into financial markets. As the old adage goes, markets hate uncertainty, and negative interest rates could make for a very uncertain future.

So, whatever happens here or abroad, negative interest rates are a phenomenon worth keeping an eye on.

[1]Seekingalpha.com. August 26, 2019.

[2]Source: U.S. Department of the Treasury, *Daily Treasury Yield Curve Rates*, August 30, 2019.