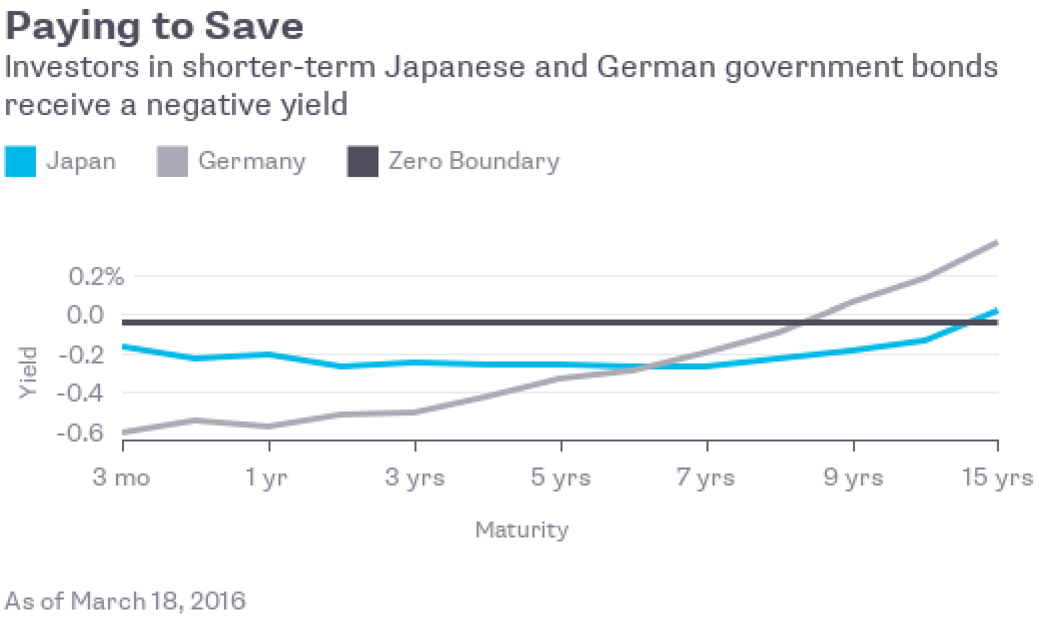
IMPLICATIONS OF NEGATIVE INTEREST RATES: Long term POSITIVE?

Imagine a bank that pays negative interest – depositors are actually charged to keep their money in an account. Crazy as it sounds, several of Europe's central banks have cut key interest rates below zero and kept them there for more than a year. Now Japan is trying it, too. For some, it's a bid to reinvigorate an economy with other options exhausted. Others want to push foreigners to move their money somewhere else. It's an unorthodox choice that has distorted financial markets and triggered warnings that the strategy could backfire. If negative interest rates work, however, they may mark the start of a new era for the world's central banks.

Negative interest rates can weaken currencies that are too strong, provided that globally central banks do not end up competing in terms of negative rates. But their effectiveness as a monetary stimulant has yet to be seen, and they have potential negative side effects. Therefore, central banks are unlikely to use this tool too aggressively. It is anticipated that the European Central Bank (ECB) and the Bank of Japan (BoJ) would envisage deposit rates no lower than –0.5%. The Swiss National Bank (SNB) has potential leeway to lower rates to –1.25% within current bands, but is unlikely to do so unless it becomes necessary due to major economic or further financial shocks.



In theory, interest rates below zero should reduce borrowing costs for companies and households, driving demand for loans. In practice, there's a risk that the policy might do more harm than good. If banks make more customers pay to hold their money, cash may go under the mattress instead, depriving lenders of a crucial source of funding. But there is mounting concern that when banks absorb the cost of negative rates themselves, which squeezes the profit margin between their lending and deposit rates, this might result in them being even less willing to lend. The Bank for International Settlements warned in a March 2016 report of “great uncertainty” if rates stay negative for a prolonged period. And if more and more central banks use negative rates as a stimulus tool, there’s concern the policy might ultimately lead to a currency war of competitive devaluations.

The best example of what the effects could be are to be seen by the SNB, where negative interest rates have allowed the SNB to counter CHF (Swiss franc) appreciation without expanding its balance sheet too heavily after it dropped the EUR/CHF floor. The successful stabilisation of EUR/CHF around 1.10 has helped the Swiss economy to avoid recession. But the CHF has remained overvalued as Switzerland’s current account surplus of 12% of GDP and net capital inflows have kept demand for CHF strong. Negative rates have not proven particularly stimulating for the domestic economy. Corporate credit, which had been on a declining trend before the introduction of negative rates, has not turned around. Mortgage growth has been slowing in response to self-regulation by banks, which limits affordability for borrowers. And consumers have not been enticed to consume more and save less. Rising unemployment has further weighed on consumer confidence, and inflation has remained negative.

The implication for the Financial sector in particular is that negative interest rates impact banks’ net interest income, and hence profitability. Therefore, they tend to weigh on bank equity valuations and debt pricing. The most challenging combination for banks is negative interest rates in conjunction with flattening yield curves. Regulation requiring the holding of substantial high-quality liquid assets (mostly low- or zero-yielding sovereign debt) limits interest income further.

In addition, credit spreads can react negatively. Swiss bank bonds in CHF trade at 80–100 basis points, while foreign banks’ credit spreads are at 60–80 basis points. Before the introduction of negative interest rates, Swiss banks’ credit spreads were, on average, 20 basis points lower than for foreign bank bonds. So Swiss banks’ funding costs have actually increased since the introduction of negative interest rates.

There have been more risks for bonds and REITs as duration has increased significantly on the Swiss CHF bond market (from an average of 5.5 years to nearly 8 years), so the sensitivity of bond prices to interest rate fluctuations has risen. Liquidity has declined as investors have tended to buy and hold, even more so than previously. Negative rates have also contributed to a stagnation in the CHF bond market’s capitalisation, and to it becoming more concentrated on domestic issuers.

These developments have made the market far more risky for investors, which will likely prove particularly difficult for pension fund returns. Investors have also bought into real estate investments, but fundamentals are not as favourable as real estate valuations suggest, posing a risk once the Central Banks alter course and move towards a normalised rate environment. In our experience, investors need to be aware of the temptations and traps that lurk in this environment. With signs of economic recovery becoming more widespread, it will take close analysis to determine if today’s marginal projects will become tomorrow’s winning growth plays − or if a turnaround in interest rates will threaten their value altogether.

If management teams could lock in today's low cost of capital as easily as a home owner locks in a long-term interest rate, investing would be easy. Since they cannot, companies in particular must be careful in assessing a project's potential value. The best assessment should take into account both the **real** cost of capital and also an estimate of inflation / deflation.

Low productivity growth tends to be deflationary in the short run, but inflationary in the long run. As the aggregate output gap in developed economies eventually closes, bond yields are likely to move modestly higher. The word "aggregate" in the previous sentence is very important, however. The U.S. is getting close to full employment; however, Emerging Markets (EM), Europe and Japan continue to suffer from considerable unemployment and underemployment. This means that the ECB and the BoJ are unlikely to face pressure to raise rates anytime soon. Until they do, any Fed rate hikes will perform a dual role: not only will higher rates cool the U.S. economy through increased borrowing costs, but they will also keep the dollar well bid. This means that the Fed will not need to raise rates aggressively or by as much as it normally would in order to tighten financial conditions.

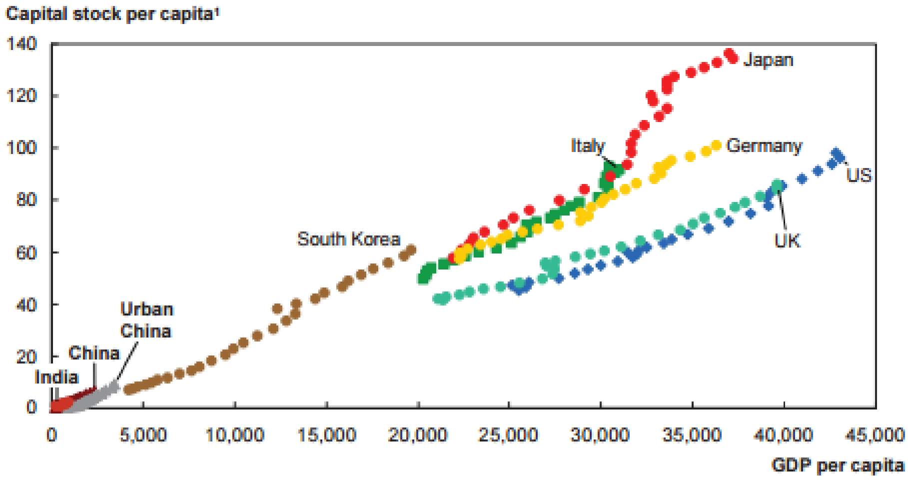
As Investors value both growth and return on invested capital, corporate managers need to calculate the best trade-offs and communicate their strategy to the market. Markets currently have produced greater monopoly rents for a narrow set of companies, which may just explain why the momentum trade on a handful of counters has driven indices, as profit margins for large-cap tech companies have risen significantly over the past decade, despite the deceleration in productivity growth.

However, across Asia, Latin America and Africa the demand for new homes, transport, water systems, factories, offices, skyscrapers, hospitals, and shopping malls will cause an increase in investment due to the ongoing process of urbanisation. Despite global investment dipping, post the global recession of 2009, the likes of China, India and EM, still considering the very low levels of capital stock that these entities have accumulated till now, will see high investment rates return in capital stock which will possibly continue for decades!

Capital stock per capita in China and India is very low compared with that of developed countries

Capital stock vs. GDP per capita by country and year, 1980–2008

$ thousand, sample of selected countries, constant 2005 prices and exchange rates



1 Stock of net fixed assets at the end of the year, assuming 5 percent depreciation rate for all the assets.

SOURCE: McKinsey Insights China; McKinsey Global Economic Growth Database; McKinsey Global Institute

In conclusion, the recent move to low and negative interest rates is on the back of economic weakness in Developing Markets (DM). There is little demand for new credit in spite of central bank monetary policies aimed at stimulating growth. The problem is that DM policymakers have been going about it the wrong way. Rather than taking steps to reduce the overhang of debt, they have been trying to get the private sector to take on even more debt by lowering and depressing interest rates, and introducing programmes, such as the European Central Bank's TLTRO (Targeted Long-Term Refinancing Operations), which essentially bribe banks to extend credit to a private sector that is already overly indebted. Not surprisingly, policymakers are discovering that in a post-debt super cycle world, the demand for credit remains structurally depressed.

This low-interest-rate environment, however, is not sustainable as governments ratchet up fiscal expenditure as urbanisation increases demand for infrastructure and commodities; corporates build plant and buy machinery, while workers upgrade their standards of living. At the same time, despite an aging population, China's efforts to boost domestic consumption will constrain global savings growth in spite of higher capital costs benefiting savers while restraining consumer borrowing behaviour.

What, then, should they be doing? The answer is relatively simple: central banks should be printing money and using that money to buy up and then cancel government debt, thus giving governments more scope to cut taxes or increase fiscal spending! The million dollar question is: wouldn't this destroy central bank balance sheets and undermine their credibility? The answer is "No", as 'Helicopter Drops' do not harm central bank solvency in any way. What helicopter drops do is flood the economy with money, pushing up inflation in the process. When inflation is too low as it is in most DMs or if there is a smell of deflation, this is a positive outcome.

This may well see the global economy entering a new era in which the need to invest exceeds the desire to save, ultimately pushing real interest rates higher; thus constraining investment and unfortunately ultimately slowing global growth – "the new normal". What then are the implications for investors? Given that the cyclically-adjusted P/E multiple for U.S. stocks is already quite elevated, it is doubtful that valuations will increase much in a low productivity environment. As such, investors should overweight cheaper markets such as Europe, Japan, and select emerging markets such as China and India.

Prepared by Mark Huxter, 5 April 2016