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Why We Believe Negative Interest Rates Will Drive Growth

Last week the European Central Bank (ECB) surprised financial markets with a more aggressive combination of stimulus measures than most investors had expected. The ECB's stimulus measures included pushing its benchmark lending rate even further below 0%, from -0.3% to -0.4%. Negative rates had been considered impossible for major financial markets until just over a year ago when the Swiss National Bank set a -0.75% interest rate target. Despite the subsequent implementation of negative interest rate policies (NIRP) in the Eurozone, Sweden and Japan, NIRP remain a new and controversial policy option for central banks. For an explanation on NIRP, see primer on page 3.

Uncertainty over the long-term impact of this new monetary strategy may help explain why equity markets, especially those in Europe, went on a roller coaster ride after the ECB announcement, at first rising, then falling quite sharply and finally ending the week with a powerful rally to close above their level before the announcement. Markets were even more unsettled in late January after the Bank of Japan embraced negative interest rates only days after assuring investors that such an option was not being considered.

NEGATIVE RATES HURT SAVERS AND BENEFIT DEBT HOLDERS, CONSUMERS, AND RISK TAKERS.

As discussed below, we believe that negative rates entail undeniable costs to savers and bank profitability but will ultimately prove to be a powerful new strategy for fighting deflationary pressures and economic stagnation. Although we believe these new tools will help push equity markets higher by the end of the 2016, we recognize that investors are increasingly skeptical of the ever-expanding array of experimental monetary policy options seen in recent years. Central bankers are no longer automatically getting the benefit of the doubt that these new policy tools will result in a stronger global economy. Global investors may need to see solid evidence of improving economic growth before aggressively returning to the equity markets.

Negative interest rates are an extreme form of "financial repression," a deliberate strategy of pushing interest rates so low that savers and other conservative investors have little choice but to move to higher risk investments. Savers have generally had to accept 0% returns on safe investments after the 2008 financial crises, but negative rates go one step further by locking in an assured loss of principal on such investments. For example, a 1-year certificate of deposit (CD) carrying a -1.0% rate of interest would result in the owner of the CD being repaid only 99.0% of their original investment.

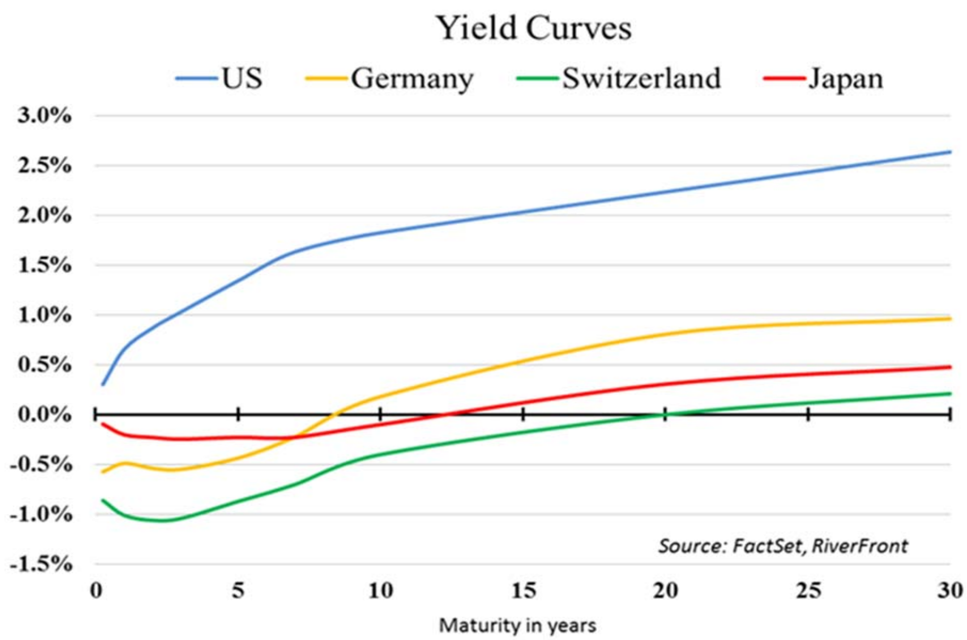
Savers could theoretically avoid these losses by withdrawing their money and simply holding cash. However, the Swiss experience over the past year suggests that the costs and risks of storing large amounts of cash, when combined with the anti-money laundering regulatory burdens associated with large cash withdrawals, force most savers to stick with their bank deposits and other conservative investment options. This ability to impose losses on savers is what makes NIRP a potentially effective economic stimulus in a deflationary environment. When faced with a "spend it or lose it" decision, consumers and businesses may choose to increase their spending despite falling prices.

Bank profitability also suffers after the imposition of NIRP. The early evidence suggests that banks are quick to pass along the costs of negative rates to their large corporate depositors, but have been much more reluctant to impose the full impact of negative rates on their "mom and pop" depositors. In addition, when rates go negative central banks move from paying interest on a bank's excess reserves to charging a fee on those reserve levels. Thus, negative interest rates add two more headwinds to bank profitability. The stock prices of banks in NIRP economies have suffered as a result.

We believe that the just-announced ECB stimulus measures include a creative potential solution to the impact of NIRP on bank earnings. The most productive way for banks to avoid the NIRP charge on excess reserves is to use up those reserves by making loans, and the new ECB policy has a carrot-and-stick approach to encourage bank lending. Banks that hit certain loan growth targets will be able to borrow from the ECB at negative interest rates. Thus, banks that make loans will both receive the benefits of a negative rate (the carrot) while also avoiding the NIRP fee (the stick). This new funding program essentially pays banks to lend money, and could provide significant economic stimulus through increased bank lending. Borrowers would receive the ultra-low interest rates made possible by negative interest rate funding, and thus loan demand may also increase under this program.

The clearest beneficiary of NIRP are the borrowers who are allowed to repay less than the amount borrowed, and the highly indebted governments of Japan and Europe may be the biggest winners in a world of NIRP. Negative rates lower the cost of servicing a country's outstanding debt and also create the potential for long-term reduction in the overall debt burden. As shown in the chart below, most of Japan's newly issued bonds are trading at negative interest rates.

THE WEEKLY CHART: US RATES PULLED DOWN FROM ABROAD



Source: RiverFront Investment Group, FactSet. Past performance is no guarantee of future results. All yield curves as of March 8, 2016.

If this situation persists long enough, Japan may actually start making money on its outstanding debt as the principal reductions from negative rate bonds eventually exceeds the amount of interest paid on older debt issues.

Negative rates in overseas bond markets also make US interest rates more attractive on relative basis, and may prevent rates from rising as much in the US as might otherwise have been the case. Although NIRP may reduce the potential downside for US bond investing, we still find 10-year Treasuries offering yields of less than 2.0% unattractive. By contrast, the near 4.0% returns available in 10-year investment grade corporate bonds look relatively compelling in a world of negative interest rates.

PORTFOLIO IMPACT: The primary impact of NIRP on our portfolios is to increase our confidence in the long-term prospects for equity markets. As more government bonds trade at a negative rate of interest, the assured loss on these investments should increase the attractiveness of equity investments, in which the potential for loss is balanced by the potential for gain (see the *Strategic View: The Swiss Tsunami,* dated January 20, 2015 for more details). In addition, most bear case scenarios for stocks entail a deflationary spiral caused by excessive debt burdens. We believe that NIRP helps reduce those debt burdens and make such an outcome less likely.

NEGATIVE INTEREST RATES: HOW ARE THEY ACHIEVED IN PRACTICAL TERMS?

First, some mechanics: banks are required to hold a certain amount of money – reserves – with the central bank. For the first time in history, the central banks that have imposed negative interest rates are charging the banks interest on those reserves, rather than paying interest on reserves as done in the US and other countries with positive interest rates.

Banks must then choose whether to do the same to their customers, i.e. charge them for holding deposits (negative interest rates) as opposed to paying interest on deposits. This has not been done before due to the fear that depositors would withdraw enough deposits to cause the banking system to be unable to function. After Switzerland, an economy very dependent on the banking industry, successfully imposed negative interest rates without experiencing significant withdrawals from depositors, other central banks gained the confidence to follow suit.

Important Disclosure Information

High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

In a rising interest rate environment, the value of fixed-income securities generally declines.

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

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