NIRP

The *New York Times* headline read "Negative 0.5% Interest Rate: Why People Are Paying to Save." Here is the link to a story that gives some perspective on this issue of negative rates. My colleague, Chicago-based Bob Malvenda, notes that the hundreds of comments on the *NY Times* piece are instructive, revealing understandings and misunderstandings surrounding this negative rate issue. You can read the article here: http://www.nytimes.com/2016/02/13/upshot/negative-interest-rates-are-spreading-across-the-world-heres-what-you-need-to-know.html

There are nearly 400 comments. Cumberland Advisors readers may want to sample some of them to check out what *NY Times* readers are saying. Four hundred is a large enough sample to allow for development of some inferences about *NY Times* readers and their understanding of negative rates.

Here are some bullets on the issue of negative rates and what they mean for investments in 2016 and beyond.

1. There is some history with negative rates, but that history is nothing like the present. The Swiss imposed a negative deposit rate years ago in order to discourage an inflow of foreign money into Swiss banks. They were attempting to stop the strengthening of the Swiss franc as foreigners sought a safe haven. According to a 2010 JPMorgan paper on this subject, "CHF appreciated through the 1970's even though a deposit charge on non-residents pushed negative interest rates from 8% to 40% by 1978." For the full discussion see http://snbchf.com/snb/2013-snb/reflections-on-negative-interest-rates-in-switzerland/. Granted, those intense negative rates were combined with capital controls and were occurring as the Bretton Woods, post-WW2, fixed-currency regime was in the process of dismembering.

2. A version of a negative rate was espoused by Silvio Gesell during the Great Depression era. For a full discussion of the "Gesell Stamp," see http://blog.supplysideliberal.com/post/56754781054/silvio-gesells-plan-for-negative-nominal-interest. Gesell's ideas received positive notoriety among prominent economists like Irving Fisher, John Maynard Keynes, and Lawrence Klein. However, interest in his proposals never became widespread.

3. The use of negative rates was discussed during the 2008 financial crisis. At the time, ECB President Jean-Claude Trichet, Federal Reserve Chairman Ben Bernanke, and other central bankers were fearful that the introduction of negative rates would have "disruptive effects" that were unpredictable. So the financial crisis was addressed with quantitative easing (QE) in multiple rounds and various configurations, and the interest rate lower boundary was set at zero. ZIRP became the acronym for the zero interest-rate policy just as NIRP is now the acronym for a negative interest-rate policy. I personally recall a crisis-era conversation in Europe at a GIC meeting. At the time I chaired the central banking series of the GIC. Three central bankers discussed negative rates. At the time, they dismissed the use of NIRP. Since then, two of them have become involved in actively pursuing a NIRP policy; the third is retired. Since the 2008 crisis, Bernanke has subsequently suggested the use of negative rates as a possible and acceptable policy tool. Last year, one FOMC committee member actually created a record in FOMC history by favoring a negative rate. That person is believed to be a president of one of the Federal Reserve District Banks and not one of the governors. He is also believed to have since retired from the Federal Reserve.

4. The Federal Reserve has ordered and is obtaining stress tests of negative rate impacts on its member banks. The Fed seeks this information to learn how negative rates affect bank capital and banks' balance sheets. The emphasis is on the

small negative rate that is triggered in the pricing of repo collateral, mostly Treasury bills. “While this is an interesting intellectual exercise, we would not read much into it as a statement of policy intentions,” says Barclays’ Joe Abate. We completely agree with Joe’s assessment and thank him publicly for his research note of February 5th.

5. Fed Chair Janet Yellen has been asked about negative rates repeatedly and with growing intensity since they were first introduced in 2014. While she has admitted that the Fed must consider them, she has not committed herself to any serious contemplation of their imminent use. Yellen has raised a question about the legality of NIRP under American law. Picture that question debated in Congress or tested in our court system. And now we do not even know what the Supreme Court will look like, let alone how it would lean on this subject.

6. Our view is that the Federal Reserve decision makers will do all they can to avoid the use of a negative interest rate policy tool. At Cumberland, we are using the no-NIRP path as an investment assumption when it comes to the United States.

7. NIRP is, however, spreading in the rest of the world. Five currencies and 23 countries are now practicing some form of NIRP. In all cases the likely outlook is for NIRP to go lower in rate and for its usage to broaden. For perspective, keep in mind that 24% of the planet’s real output is housed in those 23 countries, ranging in size from Malta (the world’s smallest economy) to Japan (the world’s third-largest economy). At Cumberland, we expect this list to expand over the next two years. We expect the level of sovereign debt trading at negative rates (already measured at several trillion) to be expanding at the rate of 100 to 200 billion per month.

8. The implications of lower and deepening NIRP policies are enormous. First, they ensure that interest rates will be at a zero or lower level for the rest of the decade in those

jurisdictions. Imagine that we are seeing commitments now for the next two years, as publicly declared by the central banks. Think about how difficult it will be to “taper” back *up* to zero from a NIRP. Our best guess is that these countries and those who join them are locked in a NIRP policy regime for the rest of the decade. At Cumberland, we are using an expanding NIRP as a policy assumption for our investment decision making.

9. The second implication of a spreading NIRP is that NIRP anywhere suppresses interest rates everywhere. The more NIRP we see, the more downward pressure on rates there will be in jurisdictions that are not under NIRP. We see that in the United States, where bond rates are positive numbers but are continually pressured to lower and lower levels. Those investors who do not understand NIRP have missed a huge rally in bonds. At Cumberland, we have invested in that rally. Only now are we beginning (and we stress the word *beginning*) to take some of that profit and redeploy it.

10. The third implication of NIRP is that it changes a key characteristic of money. Money is still a unit of measure. Money is still a facilitator of commercial exchange. But NIRP alters behaviors when it comes to money’s being a “store of value.” When holding cash equivalents creates a cost, it alters behaviors by those who are paying this cost. Thus we see jurisdictions under NIRP where folks are pre-paying their taxes or obligations. And we see corporations buying back their stock with excess cash.

11. The fourth implication of NIRP plays out in the borrowing arena. When a borrower can finance at near zero and when that borrower is assuming that NIRP will continue for a prolonged period, that borrower changes the way debt is viewed. Essentially the use of money becomes free or nearly free. We are seeing early signs of that now. Borrowing at very low or even negative rates for acquisitions is a growing activity because of NIRP. We expect that process to continue and

accelerate as the use of NIRP spreads and as the interest rates in NIRP countries go even lower than the present levels.

12. The fifth and a huge implication of NIRP is its impact on asset prices. Remember, NIRP assures that the riskless rate will be zero or lower for years to come. With that assumption in place, the prices of assets rise and rise. The longer the duration of those assets, the higher the prices can rise. Stocks, real estate, collectibles, and annuity streams of all types have an upward bias in price as NIRP spreads and deepens. As long as the creditworthiness of the asset is not impaired, the valuation of that asset will inevitably rise. We have seen that happening in very volatile terms. This volatility is expected, since the adjustment to NIRP is new and unfolding. But volatility does not mean only falling asset prices. VOL is bidirectional. High VOL only means the swings in asset prices are larger and more violent. But the swings happen in both directions.

In sum, NIRP is here to stay for a while. It is expanding. It means the zero or lower rate pressure is likely to be around for many years. It is bullish for asset prices. It is repressive for traditional savers. It is altering behavior as the store of value characteristic of money is distorted or replaced by NIRP. Whether we like or do not like NIRP is irrelevant. We have NIRP. The best outcome we see is to accept it and act accordingly.

Torsten Slok of Deutsche Bank Securities has compiled an excellent list of research papers focused on NIRP. Email me if you wish to see a copy.