Weekly Market Flash

NIRP Nihilism

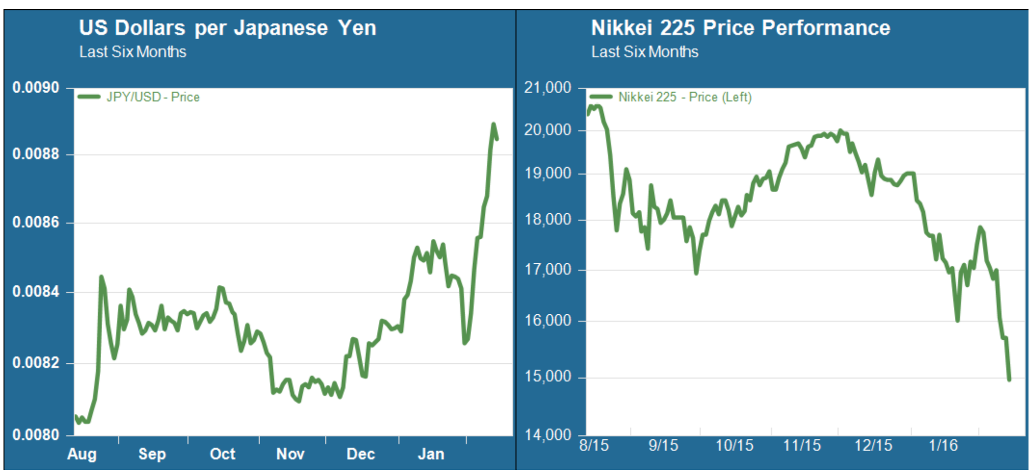
February 12, 2016

It's just a natural continuation of conventional monetary policy, say the central bankers who have unleashed the hounds of negative interest rate policy – NIRP – into the capital markets. The Swedish Rijksbank is the latest to join the club, setting the key bank overnight repo rate at minus 0.5 percent. Even stranger than the rate itself was the accompanying announcement, part of which read thus: "Growth in the Swedish economy is high and unemployment is falling, which suggests that inflation will rise in the period ahead".

Got that? Sweden's economy, in fact, is growing at a clip of around 3.5 percent, or more than twice that of the Eurozone. If US GDP were growing by anything close to that rate it's a pretty sure bet that Janet Yellen & Co. would be hiking rates with nary a second thought. What possible reason could there be for Sweden, then, to send rates below zero? "Global uncertainty" was the phrase the Rijksbank deployed in that same press release, along with a vague reference to recent inflationary weakness. "Everybody else is doing it" seems to be the underlying context, though, and that has the makings of a potentially dangerous trend.

Wonderland Not So Wonderful

We took note in this column a couple weeks back of the Bank of Japan's joining Club NIRP. Now, as with any easy money policy, two key motivating incentives for negative rates are a weaker currency (to improve trade conditions) and higher domestic asset prices. How's that working out for Japan so far? Consider the chart below, showing recent trend performance in the Japanese yen and the Nikkei 225.



Source: MVF Research, FactSet

In fact, the currency and the stock market have both done exactly the opposite of what the BoJ would have hoped. The Nikkei 225 has fallen by more than sixteen percent since the beginning of February, while the yen has strengthened by 8 percent against the dollar. Oops. The point to make here is simply this: NIRP is not, as claimed, simply an extension of the conventional easy money continuum. It is a whole new territory, an unknown land where the normal rules of finance do not necessarily apply. That NIRP is going viral around the globe is, in our opinion, cause for considerable concern.

Here Be Dragons

There are many facets to our concern about the NIRP contagion. A central one is its impact on the financial sector. The fruits of this impact are already visible in the form of a global bear market for the shares of financial institutions. Banks have to hold a certain fraction of their liquid assets in the form of central bank reserves. When the cost of holding these reserves goes up they need to make up the difference elsewhere, either in raising lending rates (counterproductive to growth) or in venturing into riskier lending areas (counterproductive to risk-adjusted capital adequacy). Again – a key objective of any easy money policy is to funnel money back into the economy via bank lending and accelerate its velocity. All the quantitative easing of the last six years has failed to accomplish this objective. It seems a great stretch to imagine that, suddenly, credit demand is going to materialize out of nowhere in response to negative rates. The banks, meanwhile, will have to figure out how to adjust their business models to remain profitable.

The reasoning behind NIRP is also flawed in terms of its capital markets objectives. Negative interest rates have spread into a widening swath of fixed income instruments, primarily (though not exclusively) government bonds. Five year German Bunds currently trade at negative yields, as does the Swiss ten year note. That's right – if you buy a Swiss government bond and hold it to maturity you are guaranteed to lose money. What NIRP does, then, is to take low-risk assets and make them riskier – a complete perversion of standard capital market theory.

No Country for the Prudent Investor

Bear in mind that institutional investors like pension funds and insurance companies are required by their investment policy statements to hold sizable percentages of low-risk assets in their portfolios. Part of the NIRP objective is to make safer assets less attractive to stimulate purchases of riskier assets like stocks. But a prudently managed pension fund cannot simply take itself out of short term bonds and dump the money into small cap stocks. In this way, again, NIRP is counterproductive.

Finally, NIRP could potentially achieve the opposite of what it wants in terms of guiding inflation back up to those elusive 2 percent central bank targets. Think again about that ten year Swiss government bond we discussed a couple paragraphs above. Nominal bond yields are comprised of two sections: an expected real return (i.e. what the investor expects to earn from the investment after inflation); and inflationary expectations. Say for example that a certain ten year bond yields five percent and that inflation is expected to run at two percent for the next ten years. So that bond's real return would be three percent and the inflation expectations component would be two percent. Easy math.

In light of that example, what does a yield of negative 30 basis points (about where the Swiss ten year is today) tell us about investor expectations? Only that for a rational investor to hold that security, the investor would have to believe that the most likely price trend for the next ten years would be deflation. If the average price of goods and services in the economy were to fall by one percent annually for the next ten years then it would make sense to invest in a bond, the slight negative return of which would still preserve purchasing power. Of course, deflation is exactly what financial policymakers want to *avoid*.

Expectations matter in explaining economic behavior and outcomes. The advanced-math models central bankers use in arriving at policy decisions have been shown to be demonstratively poor in accounting for the expectations factor. Want proof? Go back to that chart showing what the yen and the Nikkei 225 did in the aftermath of the BoJ's NIRP decision. Expectations matter, and central banks ignore them at their – and our – peril.

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