PRICE VALUE PARTNERS

Don't be so negative

"FED'S WILLIAMS SAYS IN A DOWNTURN WE COULD CONSIDER QUANTITATIVE EASING, NEGATIVE RATES."

- Tweet by Reuters' Jennifer Ablan, reporting on a speech by John Williams of the Federal Reserve Bank of New York at the Economic Club of New York, 6 March 2019.

"Because NIRP worked so well in Europe and Japan ?"

- Response by mac on Twitter.

In February 2016, *The Financial Times* published an article titled 'Central Banks: Negative Thinking', co-authored by Robin Wigglesworth, Leo Lewis and Dan McCrum. The piece in question was atypically sceptical of the received wisdom of QE, i.e., that it works. If it was sceptical as to the efficacy of QE, it was doubly so in relation to the policy of maintaining negative interest rates, or NIRP. Some extracts follow:

> Online, the mood has turned to rage. Forums have seen a flood of commentary from Japan's retirees decrying negative rates and the "torture" that the BoJ's policy is already inflicting. "Raising commodity prices to overcome deflation, raising consumption taxes, lowering interest rates . . . they are all policies that make us suffer," wrote one..
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> The Japanese can be conservative at the best of times, and few think these are the best of times.
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> But Japan is not the only country affected. A concept once only subject to small-talk among economists is now an uncomfortable reality. With quantitative easing seemingly losing its power to dazzle markets, and many governments either unable or unwilling to countenance raising spending, central banks have felt compelled to try new tools.
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> Sweden, Switzerland, Denmark, the eurozone and most recently Japan — adding up to almost a quarter of the global economy — have all introduced some form of negative interest rate policy in an attempt to fight deflationary forces, weaken their currencies and stimulate growth. Some analysts believe the Federal Reserve will have

> to follow suit despite its move to raise rates in December for the first time since 2006. Janet Yellen, the US central bank's chair, has admitted that policymakers have at least considered the possibility.
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> Markets have generally applauded every central bank move to ease monetary policy since the financial crisis, but have grown anxious over the negative interest rate experiment. Some investors and analysts fear the moves are an alarming reflection of dwindling central banking firepower, and that the new weapon could even be dangerous.
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> "Policymakers may have significantly underestimated the economic risks," Scott Mather, one of Pimco's chief investment officers, said last week. "It seems that financial markets increasingly view these experimental moves as desperate and consequently damaging to financial and economic stability.."
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> Economists had assumed that people would rather hold physical cash than see it slowly winnowed by charges. But the initial experiments have shown that banks are reluctant to actually impose negative rates on their depositors. As a result, policymakers seem increasingly taken with this novel monetary lever to lower borrowing costs, despite fears about the impact on the banking sector..
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> "I see negative nominal interest rates as a potentially powerful tool for central banks," Naranya Kocherlakota, the former head of the Minneapolis Fed, said this month.
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> The policy can lead to some odd phenomena. Eva Christiansen, a Danish sex therapist, last year signed a three-year business loan with a negative interest rate, which in practice meant the lender had to pay her about DKr7 ($1) a month — vividly underscoring how the experiment can hurt banks. The concern is that the business model of the better-capitalised but still-fragile banking industry will become even more challenging with sub-zero interest rates.
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> Deutsche Bank strategists have compared the policy to weapons of mass destruction, escalating a currency war that will only bring "mutually assured destruction", and said central banks need to find a "better bazooka"..
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> "If you are being charged 50 basis points, why not take it out in €500 [notes] and put it in a safe?" says Charlie Diebel, head of rates for Aviva Investors. "It becomes viable to store cash under the mattress, so to speak."
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> Back on the Japanese forums, one man in Yokohama with a following among elderly users, frets: "I am scared and I think a lot of people who are living on investments and savings are scared. These investments were presented to us in normal times, but the times we are living in are not normal."

As analysts at JP Morgan remarked at the time, the most insidious aspect of negative interest rates is what they they signal: that central banks are at their wits' end over how to stimulate growth and ward off the spectre of deflation. The concern, back in 2016, was that the US was poised to join in. Now, from the vantage point of 2019, given John Williams' warning cited above, it looks like NIRP from the Fed might be back on the table after all. It's a little like a line from the sketch show 'Not the Nine O'Clock News' from the 1980s: having been late for World Wars One or Two, the US is determined to be ahead of events for the next one.

In the entire pantheon of lunatic policies foisted on a confused public by comparably confused central banks, nothing quite matches the idiocy of NIRP. It suspends rationality entirely. It bucks all laws of economics and all principles of fairness and common sense. It punishes the prudent without obviously benefiting anybody other than fiscally imprudent governments (that is to say, nearly all of them). In the words of John Stepek of MoneyWeek, it is the weaponization of compound interest. NIRP is giving a Kalashnikov to a baby chimpanzee.

The analyst and financial historian Russell Napier, in an interview with the website Financial Sense, shared some of these concerns:

> So [with negative rates] there are business models that don't make any sense. Elsewhere, the more the rate on deposits comes to negative, the more risk there is that people start asking for bank notes...that's a bank run if we ever get to that stage, but even with negative rates where they are it's destroying the returns for banks.
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> When you've built over hundreds of years a system that runs on positive nominal rates and you suddenly deliver negative nominal rates, then you are creating lots of problems for lots of existing business models and it's going to cause havoc and I think it is causing havoc..
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> Can [negative rates] come to the United States? ..the answer is probably yes. Once again, it really depends on how quickly the politicians get in gear. Central banks I think are crying out for help from the politicians in terms of getting some form of reflation going...so I would forecast that America probably will get to negative nominal rates.
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> I do think that what's going on in the world with European banks and in the high yield market in the United States and the potential defaults in the emerging markets, I do think that's negative for US economic activity; I do think inflation will continue to come down in the US; I do think the US will report deflation, so probably the United States has to go the same place as most other places have gone to.
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> The most important thing that your listeners need to remember is that just because central banking has played out doesn't mean to say that the [political] authorities have played out. So they'll be back with some sort of political machinations to try and produce this higher level of nominal GDP growth.. and eventually they'll succeed but, crucially, it needs a crisis to galvanize the political process.

FT readers growing increasingly concerned at the absurdity of current monetary policy occasionally get a polite hearing in the Letters page, like a demented elderly relative who is reluctantly granted an audience out of pity. But on the less heavily intermediated website, they give it all with both barrels.

Here, for example, are some of the reader responses to 'Central banks: negative thinking':

"If all depreciate their currency with this latest coordinated gimmick, none does, as matters remain as they were before. So that excuse for this nonsense (negative rates) is invalid";

"It's rather odd how, when QE is intended (or so they say) to stimulate demand, they give the money to a relative handful of people with plenty of it already";

"NIRP is supposed to make us spend the money that we carefully saved for future needs. This madness will bankrupt us all - in old age (if not sooner). The 2008 crisis taught us: Never. Trust. Banks. The years since then have taught us: Never. Trust. *Central.* Banks. Either";

"There is no way on God's earth that a free market would ever result in negative interest rates. If anyone had asked you ten years ago if you'd stand for this - you'd have said 'no'. The fact that this seems almost normal to many people is an indication of just how insidious these moronic policies are. We are like frogs in a pot being boiled alive one degree at a time. Time to get out of the pot before we're all too drowsy to notice";

"Central banks will also need to explain just how they think that taking money from savers with low rates - lower than inflation - is going to give governments more taxes or businesses more customers. All it does is reduce private consumption and lower prices i.e. what they claim to be trying to stop";

"Economists rather than face reality, come up with new solutions such as negative interest rates rather than face the fact that their theories were plain wrong. At the heart of the problem is that a small group of academics or anyone for that matter can forecast the economic future better than a marketplace. In fact they are worse.."

"Central Banks, by falsifying interest rates, herd markets in a direction determined by the Central Bank. From day one these ideas were implemented, they were doomed for failure. Central Bankers do not believe in the business cycle which if left to run their course, and too much leverage employed, are normal and healthy. But for an economist that means their profession loses influence; they won't let that happen";

"NIRP is madness. The only possible positive objective may be to weaken the currency, which in itself is a self-defeating move, leading to currency wars. Switzerland adopted NIRP for this purpose. BOJ followed suit, for lack of any other alternative, and is failing miserably. The only winners of NIRP are governments and borrowers. Credit demand remains strong only with risky borrowers, including governments. Well financed borrowers borrow to buy back shares or engage in M&A not to expand the economy, but to retrench. All others are losers of NIRP, including financial institutions, all investors and households. NIRP is not a zero-sum game, but a minus-sum game. One does not have to be very bright to understand this equation, including myself."

"The FT appears to be finally seeing some chinks in the armour of the QE policies it advocates with such enthusiasm";

"What is it that central bankers and economists do not see?"

"For any human being making economic decisions, everything changes at 0%. The decision making for savers, consumers, SMEs, etc. grinds to a standstill. If you are prudent and don't want to speculate on buying various financial assets, 0% kills any reason you may have had to take any positive action. If all you can expect to get from your efforts is to still have the same as when you started, why bother? We as humans need a positive "Narrative" to get out of bed in the morning, work, take risk, etc. Risk free interest at 0% translates into a clear statement that there is no future to discount cash flows over or to believe in. If an individual cannot imagine a positive results from his/her actions, he/she prefers to do nothing. Prolonged periods of 0% rates and no positive (inflation) price movement will lead to reduced economic activity. Not exactly the stated purpose of the QE experiment. QE will go to the history books as one of the greatest mistakes in history."

Faced with a terrible threat, we can do nothing, or we can do something. Writing as a fiduciary investor, one rational response is to try and identify defensive investment choices that will go some way to putting capital to productive work without incurring entirely unacceptable levels of risk.

In an environment of heightened financial repression and the growing likelihood of the imposition of negative nominal interest rates, we think those investment choices should include high quality and unconstrained equities offering an explicit margin of safety; uncorrelated, systematic trend-following funds, and hard assets, notably gold.

It used to be said, 'Don't fight the Fed'. In 2019 we repeat what we said back in 2016, when this monetary insanity first became widespread. Now, as investors, if we want to protect our capital, we are all ***obligated*** to fight the Fed, and its international cousins, with whatever we have.

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