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## “Nega-Coups”

What do you call a bond which carries a negative interest rate? It's called a “nega-coup,” short for negative coupon. Negative coupons, or interest rates on bonds, is a rather novel reality in today's sovereign debt (government backed) market. These are government bonds (mostly issued in Europe and Japan) where the investor is **guaranteed** to lose money if the bond is held to maturity.

Let me give an example. Currently, German two-year government bonds are yielding -0.21 percent. If an investor purchased \$10,000 of these bonds, they would receive \$9,958 back in two years. **That return is guaranteed by the German government.** Recently, interest rates out to nine years were negative in Switzerland. Germany's rates were negative out to six years, Denmark out to five years, and Sweden out four years.



***The purpose of my commentary today is to answer the question: What are the implications of negative interest rates on the global economy and the world's banking system?***

### Background

Nega-coups are not new. Certain interest rates in Sweden were negative from 2009 – 2010. The same was true in Denmark from 2012 – 2014, and now Germany, Finland and Switzerland all are issuing bonds with negative attached interest rates. According to the *Wall Street Journal*, 16 percent of all outstanding government bonds (on a global level) currently carry negative yields.

The nega-coup concept violates a long-held economic presumption that interest rates cannot go below 0 percent. Why? In theory, if an investor has to pay someone to simply “hold” their money, the investor will forgo savings and increase consumption as their wealth is bound to decline in the future. That is the theory...which has now gone out the window.

## Why Negative Interest Rates Are Happening

Why has this happened? Why are so many government-backed bonds now carrying negative yields? As I have written before, the world is starving for growth. Frankly, the world is lacking growth and **deflationary forces** have been accelerating. Additionally, inflation has been declining in most parts of the globe. The “euro-zone’s” inflation is currently -0.3 percent. The most recent release shows inflation at -0.1 percent in the United States. I have written extensively on deflation in the past. Please [see my recent economic thought piece](#) for more on inflation.

The core reason rational investors accept built-in negative returns on their capital is because they believe deflationary forces will accelerate moving forward, and interest rates will become even more negative. Could this happen? Sure. Will this happen? We obviously don’t know, but the ramifications negative interest rates bring forward to the global banking and capital market pricing system are important.

## Dysfunctional Governmental Control Systems

In an attempt to overcome building deflationary pressures, many governments have little choice but to lean heavily on central banker’s policies and strategies rather than use other methods of changing financial market behavior. There are three macro-economic “tools” which functional governments are able to utilize in an attempt to spur final demand growth:

- Fiscal policy
- Monetary policy
- Currency policy

Politicians, (through spending and taxing (fiscal) policies), treasury officials, and central bankers control two of these levers (monetary and currency). These policies need to be coordinated so they don’t contradict each other. Generally, this is how policies are affected in the United States. In Europe, central planners in Brussels only control two levers -- monetary policy and currency policy. The fiscal policy issues are controlled by 19 various sovereign governmental bodies, which don’t necessarily coordinate their spending and taxation policies with the monetary and currency policies radiation from Brussels. Therein lies the base case of why, in its current state, the Euro will not survive long-term as a currency system.

***Many European economies are now operating in a dysfunctional mode where 20 independent bodies (19 sovereign governments and one central bank) are making macroeconomic policy decisions on, what appears to be, an uncoordinated, independent basis.***

As the world starves for growth, central bankers and Treasury officials in various countries are attempting to drive investors’ preferences away from “safe” assets towards more risk-based assets. With short-term interest rates at 0 percent (or lower), banks are being penalized by holding large deposits at central banks. Regulators “charge” insurance and other fees to banks on these balances. Consequently, certain banks are facing negative interest rates on reserve cash balances.

## Implications of Negative Interest Rates

Negative interest rates could have serious implications on the European banking system and global asset markets. These ramifications are centered in two macro arenas – banking behavior

and investor behavior. Let's step through the potential ramifications of negative rates:

- **European Banking System:** As central bankers impart negative deposit rates on commercial banks, monetary reserves at central banks could decline as charges accrue for the depositing banks. What could the banks do with this capital? They could lend it, or invest in assets other than sovereign securities (treasury bonds/notes). This will, in effect, lower the reserves banks hold. This is probably the scenario central planners hope for. They want banking activity to accelerate, bringing on additional economic lending and spurring economic activity.
- **Depositor's Reaction:** Instead of holding lower levels of reserves, banks could charge their depositors a fee for large cash balances. The fee might make large depositors seek alternative investment vehicles, pushing capital out of the banking system into more "risk-based" alternatives. Getting capital out of non-productive reserve balances and into the "real" economy is probably what central planners are attempting to achieve.
- **Back in the United States:** This has already started happening in the United States. J.P. Morgan recently stated they will charge large depositors upwards of 5.5 percent to hold cash at their institution. J.P. Morgan is trying to push about \$100 billion in deposits off their balance sheet because U.S. banks have to pay FDIC insurance on every dollar deposited within their institution even though only \$250,000 of deposits are insured by the FDIC against loss. These charges are more for larger banks.
- **Bankers in tough spot:** Some would say "The banks just have to get busy lending money to borrowers". Not so fast. Banks are required to hold "high-quality liquid assets" (HQLA) at somewhat high levels. This is sound banking. If a bank's delinquent loan rate starts to rise, it needs reserves to lean back on to remain liquid. This required capital ratio should be in the 8-10 percent range. Regulators are risking banks becoming much more aggressive in their lending standards – potentially returning to the good old days of 2007 – 2009. Remember those days?
- **Implications of investor reaction to nega-coups are significant:** To seek reasonable returns, investors who would normally purchase and hold European sovereign bonds may look elsewhere in the world for investment opportunities. Lower interest rates occur in markets which otherwise would be higher (the U.S. Treasury market is a direct example).
- **Negative interest rates should also continue to add to dollar strength in relation to other currencies:** Negative interest rates should put upward price pressure on foreign equity prices, as investors move capital away from "guaranteed" losses in European bonds toward more risk-based asset classes.

In summary, the shorter-term impact of negative interest rates could be higher asset values in countries where investors seek reasonable returns and move capital from negative interest-rate bearing deposits/bonds toward assets which support positive, absolute and "real" returns. While this all sounds fine and good, the costs of negative interest rates are real. As banks will be loath to hold high-quality reserve assets, the banking system could become more levered and risk-based than has been the case since 2007.

## The Sustainability of Nega-Coups

How long could negative interest rates be with us and what are the traditional market-based

variables which determine the level of interest rates? The following is a breakdown of these variables, assuming the current state of affairs in Germany and examining the two-year German

| Variables – Current Level                      |        |
|--|--------|
| German Inflation (12-month trailing CPI)       | 0.10%  |
| Credit Risk Premium                            | 0.00%  |
| Term (time)                                    | 0.20%  |
| Theoretical “Market Based” Interest Rates      | 0.30%  |
| Current 2-Year German Sovereign Interest Rates | -0.21% |
| Current Interest Rate “Distortion”             | -0.51% |

government bond rate structure and by applying rational market pricing structure:

It appears rational market pricing is distorted. Some may wonder if interest rates are too low. Interest rates are probably too low if the market were to solely drive interest rate levels, but that hasn't been the case since the days before the Great Depression.

But if nothing else, I am a realist. Reality tells me that German interest rates are at -.21 percent. ***If growth starts to be rekindled in Europe, the days of nega-coups may quickly become a memory as inflation expectations could revive and rational marketing pricing structure discipline returns.***

We will be back next week.



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