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Less Than Zero

"Operations for profit should be based not on optimism but on arithmetic."

- ***Benjamin Graham***

This letter is about a very interesting phenomenon happening to interest rates around the world, and what it could mean to you.

Less than Zero

You may have noticed that interest rates at your local banks and on money market funds have been close to zero, and have been that way since 2009. But the good news is that most likely, you're still making something (even if it's very small) from deposit accounts and money markets.

That might not be true if you were living in Europe. Interest rates have plunged across Western Europe in recent months. In Denmark, at least one bank is paying its depositors not just near-zero interest, nor zero interest, but *negative* interest[1]. In other words, the bank pays you nothing and charges you for the privilege of keeping your money with them (that's on top of the other fees that many banks charge).

Negative interest rates have historically been thought of as impossible. On the surface, negative interest rates make little sense. Why would any person agree to lend someone $1.00 in return for $0.98 in five years? Why not just keep that $1.00 in cash and still have $1.00 in five years?

Indeed, until this last year, sustained negative interest rates were broadly thought of as absurd. Many thought that there was a "zero lower bound" on interest rates. But what was seemingly impossible has become reality, and has had very real effects on the financial markets.

Bonds and Interest Rates

As we mentioned, one place where this has become obvious is the European bond market, where some interest rates* have become negative.

Last month, Switzerland became the first country in history to issue 10 year bonds with a negative interest rate[2]. Bond investors are essentially *paying* the Swiss government to give it a ten-year loan.

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The governments of Austria, Belgium, Denmark, Finland, France, Germany, and Sweden also have bonds currently paying negative interest rates[3].

Negative interest rates haven't just benefited governments. Even Nestle (the chocolate company) saw its corporate bonds generating a negative interest rate[4].

With negative interest rates, these bonds promise a **guaranteed loss**** – and investors are still buying them.

So why would anyone own these bonds? It's not just because they love Switzerland or chocolate.

Some investors buy these bonds because they simply have no choice. There are funds - including some mutual funds and pension funds – that are committed to buying certain types of bonds, even if those bonds have negative interest rates. Some pension funds are legally obligated to buy certain types of bonds, no matter the rate or lack of rate earned.

Additionally, various European government banks, led by the European Central Bank (ECB), have been buying up bonds in an effort to stimulate the European economy. These central banks have found that there are often few bonds available to buy other than those with negative interest rates[5].

Others buying these bonds are simply speculators. They believe interest rates will go even lower. Suddenly that bond with a -1% interest rate becomes more valuable when interest rates for similar bonds drop to -2%.

Lastly, other investors buy these bonds as protection against other sorts of risks (such as deflation and currency risk).

Will negative interest rates spread to America? It's hard to say, though in the short term it seems unlikely. But with the "zero lower bound" having been broken, it can no longer be considered impossible.

Why are negative interest rates relevant to you?

Let's assume an investor buys a bond with an interest rate of -2%. Let's also say that it's a 10-year bond.

Then imagine that interest rates rise, so that banks starting paying 3% on savings accounts. Suddenly, the investor has his money trapped in a bond where he is losing 2% per year, while it could have been in a bank generating 3% a year in profit.

The investor is then faced with two choices. One option is to wait out the entire 10 years of the bond, where he would then be guaranteed with a loss. The investor's other option is to sell the bond on the open market – but to entice other investors to buy it, the bond would have to be sold at a discount. Either way, that investor would likely be looking at losses.

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Those potential losses are something we call “interest rate risk”. Unlike mortgages, some bonds can’t be “refinanced” – an investor in German bonds can’t call Berlin and ask for a raise in bond payments when interest rates rise.

Interest rate risk tends to be highest when interest rates are low[6]. These days, as many rates reach all-time lows, managing interest rate risk has become even more crucial to the security of your portfolio.

Bonds are typically considered “safer” than stocks – but they are also exposed to completely different kinds of risks. As your financial advisor, part of what we do is to monitor these risks and manage how it affects your portfolio.

Please feel free to call with any questions regarding the issues we discussed in this letter or any other financial matters on your mind.

My very best,

Derrick

* For simplicity’s sake, in this letter we have used “interest rates” in lieu of “yields” when referring to bonds. The two have an equivalent meaning.
** When held to maturity.
[1] http://www.wsj.com/articles/danish-lenders-take-unprecedented-steps-to-combat-negative-interest-rates-1423576590.
[2] http://www.reuters.com/article/2015/04/08/swiss-treasury-idUSL5N0X52TR20150408.
[3] http://www.investing.com/rates-bonds/european-government-bonds.
[4] http://www.reuters.com/article/2015/02/05/us-markets-saft-idUSKBN0L92XP20150205.
[5] http://www.wsj.com/articles/ecb-bond-buying-program-could-hinge-on-german-debt-supply-1427726354.
[6] An increase in interest rates will typically have a greater price effect when yields are lower, all else equal.
[7] *Written by Chris Whatley with R.C. Whatley & Company*
[8] Raymond James is not affiliated with and does not endorse the opinions or services of Chris Whatley or R.C. Whatley Co.

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