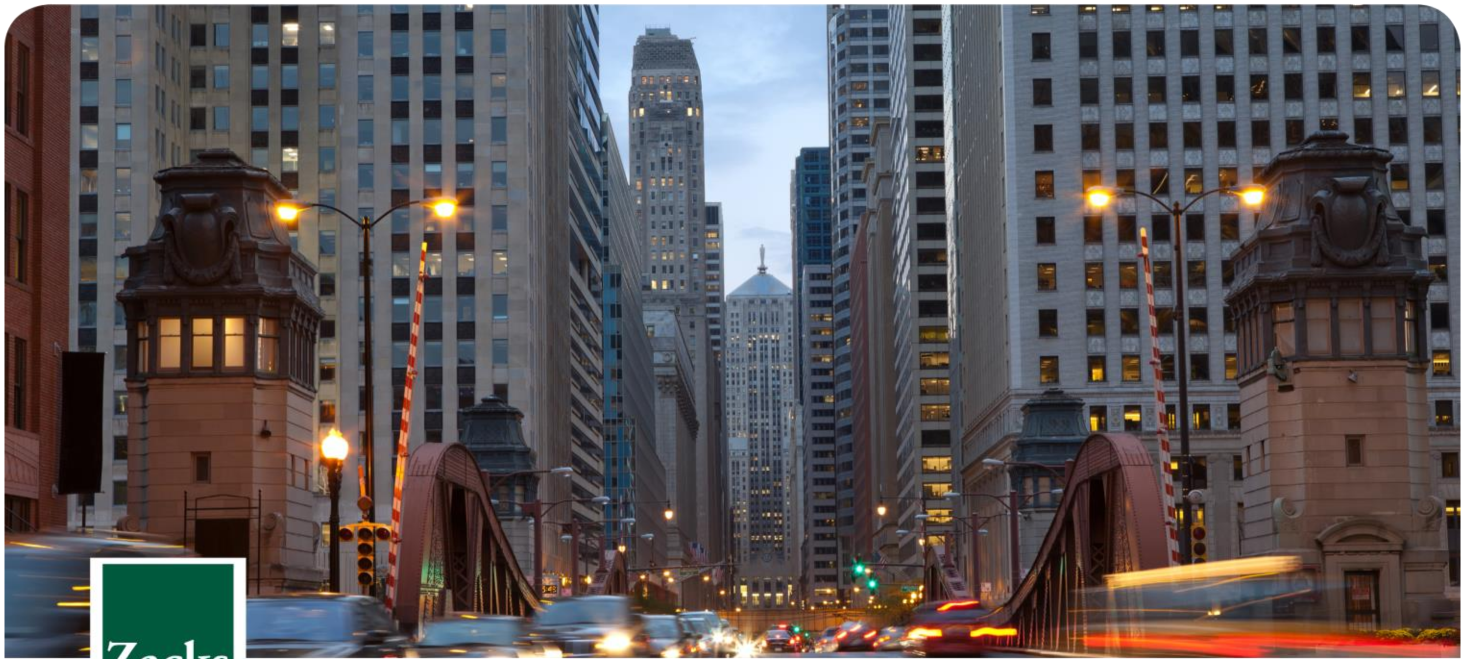

Mitch on the Markets

Negative About Interest Rates in the U.S.?

By Mitch Zacks
Senior Portfolio Manager

Janet Yellen raised eyebrows earlier this month when she hinted at the possibility of negative interest rates in the U.S. "We wouldn't take those off the table" were her exact words. Since then, I've gotten a few questions about whether negative rates could be a useful tool in stimulating the economy or whether this is a sign of central banks grasping desperately for that objective.

Truth is, there really isn't enough historical evidence to outright support or refute negative rates. Here at Zacks Investment Management, we can't really ascertain the probability of success. Since it's a new central bank policy mechanism, it's very much a wait-and-see experiment. But, on pure economics, I'd call the idea of negative interest rates, well, negative.

The Theory and Goal behind Negative Interest Rates

First, a quick explanation of why central bankers think this *might* work. Through profitable operations over time, large banks build up cash reserves. A central bank, like the Federal Reserve, gives banks a place to 'park' some of those reserves for safe keeping and build up reserves to hedge against downturns. A central bank, in turn, uses interest rates (or laws, like Dodd Frank) to encourage or deter banks from keeping excess reserves at the central bank.

Central banks hope that, if they pay low levels of interest on reserves, banks will instead choose to loan that money out at a more attractive rate. If a central bank is paying 2%

on reserves, but a bank can initiate a 30-year mortgage at 5%, the bank would probably rather make the loan – net interest margins are much higher. If conditions are such that banks would rather lend, and take risk instead of just letting reserves 'sit there,' then the economy benefits via more lending activity and favorable credit conditions – and growth usually follows.

When central banks initiate *negative* interest rates, however, not only are they dis-incentivizing banks from keeping excess reserves parked there, they are also *making them pay* to keep reserves parked. Central banks are trying to force the hands of banks to lend, and that's not good policy in my view. The ideal economic circumstance is when banks *choose* to lend because the yield curve is upward sloping, net interest margins are attractive and the economy is strong enough to support risk taking. You could argue that all three of those factors are in a middling phase that negative rates won't fix.

Europe and Japan are trying the approach anyway and, again, this "tool" hasn't been around long enough to know whether it might stoke lending. One bright spot is that the European Central Bank protects banks from suffering losses (through negative rates) on the reserves it legally requires them to have, which is about 15% of the total. Sweden actually makes banks pay interest on reserves it makes them keep at the central bank by law! An insensible policy.

Bottom Line for Investors

The overarching reality is that negative rates in the U.S. probably won't happen anytime in the next few years and, by then, we'll know whether or not it produced the intended results in those countries that have gone that route.

It's a bit of a crapshoot for banks. On one hand, in the aftermath of the financial crisis, central banks are requiring a build-up of reserves to weather the next potential downturn. On the other hand, they want banks to lend more so that economic growth gets support. It's a mixed message and markets don't like mixed messages. They like to be left alone.

Lending activity in the U.S. is healthy and growing, a sign that banks are generally comfortable with the economic environment. Negative interest rates would probably only serve to make banks feel pressured, and that's not good. Better, in my view, to avoid that outcome.

- Mitch

About Mitch Zacks

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

ZACKS INVESTMENT MANAGEMENT, INC.
www.zacksim.com

Disclosure:
Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice.

Any views or opinions expressed may not reflect those of the firm as a whole. Third-party economic or market estimates discussed herein may or may not be realized and no opinion or representation is being given regarding such estimates. This material has been prepared by Zacks Investment Research (ZIR) an affiliate of Zacks Investment Management, Inc. (ZIM) on the basis of publicly available information, internally developed data and other third party sources believed to be reliable. Neither ZIR nor ZIM has sought to independently verify information taken from public and third party sources and does not make any representation or warranty as to the accuracy, completeness or reliability of the information contained herein. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal.

Indexes:
The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large company stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees or other expenses. The volatility of the index is materially different from the individual performance obtained by a specific investor. An investor cannot invest directly in this Index.