Monthly Commentary

March 2016

Saying “no” to NIRP

For over 100 years, the Food and Drug Administration (FDA) and its predecessors have regulated pharmaceuticals in the United States. The general standard they have applied is that before a drug can be sold to the public, it has to be proven to be both “safe and effective”. The testing procedure is long and rigorous but it has had the distinct advantage of protecting the public from quack remedies that do nothing to cure the disease for which they are prescribed and come with very serious side effects.

There is, unfortunately, no FDA to regulate the behavior of central banks and since the onset of the financial crisis in 2008, they have applied some extreme and untested forms of stimulus, first to stabilize financial markets and then to stimulate stronger economic growth. These remedies have generally succeeded in the first task and failed in the second. The financial crisis is over. However, the economic expansions in the U.S., Europe and Japan all remain anemic by historic standards.

In response, rather than carefully reviewing the way monetary policy is interacting with the economy, central banks have pressed ahead with ever more exotic forms of stimulus, including cutting overnight rates to near zero levels, implementing quantitative easing programs and employing schemes designed almost to bribe financial institutions into lending. The most recent expansion of these policies has been the introduction of a negative interest rate policy (or NIRP) by which central banks seek to expand lending and spending by setting short-term rates at a negative level. (It should be noted that NIRP refers to an explicit central bank decision to set short-term policy rates at negative levels – many long-term government bond yields already trade at negative rates in Europe and Japan but that is not, technically, part of the policy).

Dr. David Kelly, CFA
Chief Global Strategist
J.P. Morgan Funds

The European Central Bank (or ECB) has three main policy rates. In shorthand, these include the lending rate, which is the rate it charges banks to borrow from it, the main refinancing rate, which is the rate it sets for interbank lending and the deposit rate, which is the rate it pays banks on their deposits at the ECB. In the world's latest dose of NIRP, on March 10, the ECB cut its lending rate by 0.05% to 0.25%, the main refinancing rate from 0.05% to zero and the deposit rate by 0.1% to -0.4%.

These changes were accompanied by a further expansion and extension of its asset purchase program (now up to €80 billion per month and including some corporate bonds for the first time) and a new round of targeted long-term refinancing operations, designed to lend very cheap money to banks (in many cases with negative rates), provided those banks increase private sector lending.

In judging whether NIRP constitutes "safe and effective" monetary policy, it is important to consider first how it is supposed to help the eurozone and second the extent of its side effects.

The simplest model of how negative interest rates might work implies a full transmission of those negative rates to all rates across capital markets. When the ECB cuts its lending rate by 0.1% to -0.4%, commercial banks cut the rates they pay depositors by 0.1%, (even if it means charging depositors for the privilege of leaving money with the bank), and banks reduce the interest rates they charge borrowers by 0.1%. Borrowers, seeing lower available rates, are more willing to borrow money to buy a house or expand a business while savers, seeing negative rates penalizing their savings, are more willing to spend money today, boosting consumer spending. In addition, global investors, seeing only negative rates available for overnight deposits in euros, switch to other currencies pushing down the value of the euro and thereby boosting exports and increasing imported inflation.

There are, unfortunately, multiple problems with this model.

- First, many banks don't want to charge their customers negative interest rates on deposits for the very good reason that those customers could simply withdraw their funds. Consequently, banks either have to eat the cost of receiving less on ECB deposits than they are paying on their own or actually boost lending rates. European bank stocks fell early in 2016, partly due to concerns that negative interest rates would erode bank capital. In addition, in some instances, mortgage rates and corporate bond yields have actually risen in the wake of NIRP.
- Second, to the extent that savers lose interest income from a NIRP policy, there are significant negative income effects from NIRP. The household sector around the world is generally a net lender – that is to say they have more interest-bearing assets than interest-bearing liabilities. Thus, cutting interest rates across the board actually reduces consumer net income. This may cut costs for the government and corporate sectors. However, spending by these sectors is likely less tied to income than for consumers.
- Third, very low or negative interest rates on short-term accounts clearly give households an incentive to spend rather than save. However, most of this money is likely earmarked for long-term savings and so is more likely to end up as cash in a safe or being reinvested into a financial asset rather than pumped into the real economy. Moreover, even if this promotes higher asset prices, it is not clear that this will translate into a positive "wealth effect" for consumption, as investors will also have marked down their expectations of the income that could be produced from a given stock of financial assets.

- Fourth, an unspoken goal of the ECB in introducing a negative interest rate policy over the past two years has been to push down the value of the euro, thus helping boost inflation through higher import prices and higher exports due to a more competitive currency. However, for the global economy, this is clearly a zero-sum game and the actions of the ECB over the past two years have forced other countries, including Switzerland, Denmark and Sweden, also to adopt negative rates to prevent their currencies from rising. In addition, the relationship between negative rates and exchange rates is highly uncertain in practice. The actual experience in the eurozone and Japan over the last two years shows that the yen and euro have, on average, risen in the weeks following the introduction and extension of NIRP.
- Fifth, all forms of aggressive and exotic monetary expansion including NIRP, have the very important and unfortunate side effects of undermining confidence in the economic expansion and increasing uncertainty. It is completely reasonable for consumers and businesses to assume that there is something deeply wrong with the economy when central banks continually introduce such drastic measures. In addition, it is extremely hard to plan in a world where the central banks continually change the rules of the financial game and potential borrowers who procrastinate are always rewarded relative to those who borrow and invest today.

These are plenty of other negative potential short-term impacts of NIRP – a TV commercial advertising it would likely be forced to disclose more side-effects than the drug commercials during the evening news. However, there is also an insidious and dangerous long-term effect. Maintaining artificially low or even negative interest rates tends to boost asset prices, particularly home prices. However, if and when the economy recovers from its slumber and inflation begins to rise again, any tightening of monetary policy could easily induce a crash in those overpriced assets. Not only is the drug ineffective with plenty of nasty side effects, but the withdrawal symptoms could be very severe.

For investors considering the ECB's experimentation with NIRP there are a few points to remember. First, while NIRP itself is unlikely to help Europe, the European economy has a lot going for it, including low oil prices, a low euro, pent-up demand, less austerity and plenty of unemployed workers anxious to be part of a recovery. Europe should be able to continue its recovery despite the best efforts of its doctors.

Second, NIRP is thankfully not on the agenda of the Federal Reserve, at least for now, as a tightening labor market and gradually rising core inflation should continue to push the Fed towards a very gradual normalization of interest rates. Because of this, investors should likely be a little overweight risk assets in the U.S. and shouldn't lose sleep over the idea of American NIRP.

However, at some time in the future, when the economy has faltered and central banks again feel the urge to ply the economy with monetary medicine, investors will need to factor in the risk that the Fed could experiment with NIRP here and the reality that it would likely prolong economic weakness rather than curtail it. When that time comes, we can only hope that, in the words of the late Nancy Reagan, the Fed "just says no".

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. It is designed to help investors understand the financial markets and support their investment decision making (or process). The program explores the implications of economic data and changing market conditions for the referenced period and should not be taken as advice or recommendation.

The views contained herein are not to be taken as an advice or a recommendation to buy or sell any investment in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of writing, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. It should be noted that the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yield may not be a reliable guide to future performance.

It shall be the recipient's sole responsibility to verify his / her eligibility and to comply with all requirements under applicable legal and regulatory regimes in receiving this communication and in making any investment. All case studies shown are for illustrative purposes only and should not be relied upon as advice or interpreted as a recommendation. Results shown are not meant to be representative of actual investment results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. This communication is issued by the following entities: in Brazil by Banco J.P. Morgan S.A. (Brazil); n the United Kingdom by JPMorgan Asset Management (UK) Limited; in other EU jurisdictions by JPMorgan Asset Management (Europe) S.à r.l.; in Switzerland by J.P. Morgan (Suisse) SA; in Hong Kong by JF Asset Management Limited, JPMorgan Funds (Asia) Limited or JPMorgan Asset Management Real Assets (Asia) Limited; in India by JPMorgan Asset Management India Private Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited or JPMorgan Asset Management Real Assets (Singapore) Pte. Ltd; in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Korea by JPMorgan Asset Management (Korea) Company Limited; in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Canada by JPMorgan Asset Management (Canada) Inc.; and in the United States by JPMorgan Distribution Services Inc., members FINRA/SIPC.; and J.P. Morgan Investment Management Inc.

For China, Australia, Vietnam and Canada distribution, please note this communication is for intended recipients only. In Australia for wholesale clients use only and in Canada for institutional clients use only. For further details, please refer to the full disclaimer at the end.

EMEA Recipients: You should note that if you contact J.P. Morgan Asset Management by telephone those lines may be recorded and monitored for legal, security and training purposes. You should also take note that information and data from communications with you will be collected, stored and processed by J.P. Morgan Asset Management in accordance with the EMEA Privacy Policy, which can be accessed through the following website http://www.jpmorgan.com/pages/privacy.

Brazilian recipients:

ANBIMA

A presente instituição aderiu ao Código ANBIMA de Regulação e Melhores Práticas para os Fundos de Investimento.

MI-Monthly_March2016

J.P.Morgan
Asset Management