On the Minds of Investors

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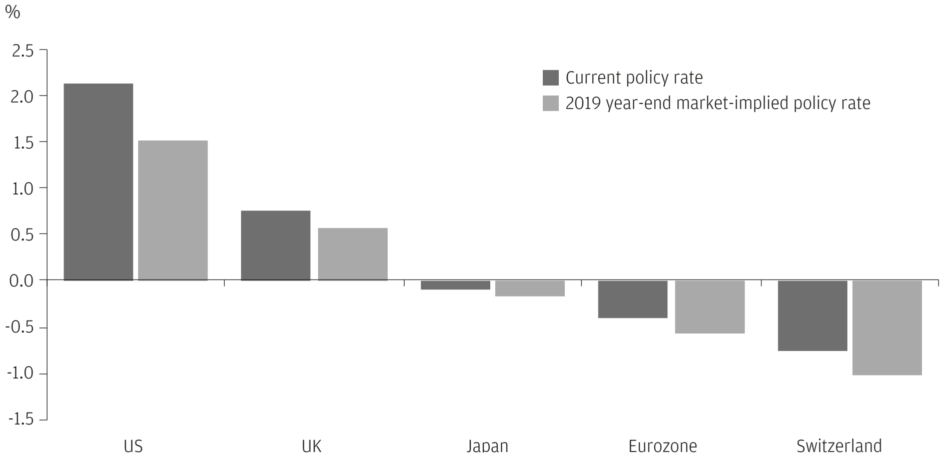
How low can they go? What do negative rates mean for savers?

A financial analyst predicting sub-zero interest rates would have been considered crazy by the vast majority of their peers just 10 to 15 years ago. Yet today, negative interest rates are a key tenet of monetary policy in several developed market economies, as central banks try to coax consumers, companies and governments to spend rather than save.

With global growth slowing and inflation below target in many regions, a number of central banks are set to cut rates further in the coming months. For some, this will mean taking interest rates deeper into negative territory. While the market's insatiable appetite for policy easing may mean that pricing in several markets is at the more ambitious end of what could feasibly be delivered, the direction of travel is clear (see **Exhibit 1**).

EXHIBIT 1: CURRENT POLICY RATES AND MARKET-IMPLIED RATES AT 2019 YEAR-END



Source: Bloomberg, J.P. Morgan Asset Management. Market-implied policy rates are calculated using OIS forwards. Data as of 22 August 2019.

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What are central banks trying to achieve by lowering interest rates?

The objective of negative interest rates is no different to conventional interest rate policy—to encourage households, companies and governments to spend rather than save, thereby supporting economic growth. Negative rates, however, have a bit more sting in their tail, since in theory any savers with money in deposit accounts will see the value of their savings slowly nibbled away.

A central bank that is cutting rates at a faster pace than global counterparts would also expect its currency to weaken, increasing the competitiveness of its country's exports. Unsurprisingly, policymakers tend not to emphasise this objective given its "beggar thy neighbour" nature. But the aim to weaken currencies does explain the current race to the bottom for interest rates, as policymakers around the world try to avoid their own currencies strengthening as a result of rate cuts on foreign shores. Even a US Federal Reserve Board member has now touted the idea of negative rates.

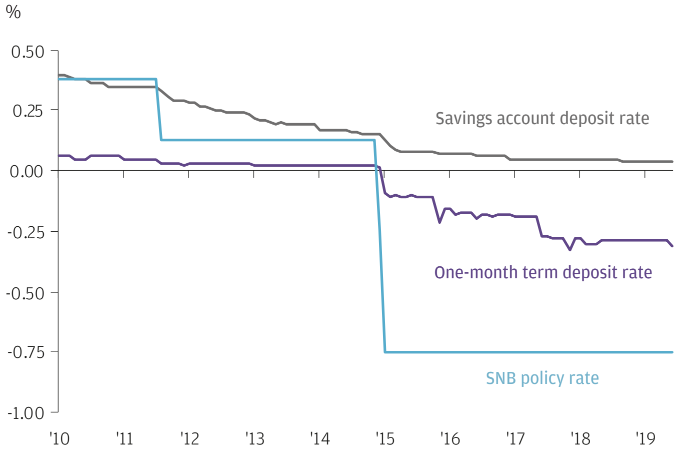
What are the effects of negative rates and how low can they go?

The theory of negative interest rates is straightforward, but the practice is not. In a paper money system, households have the option to withdraw balances and store savings in physical form—the "cash under the mattress" scenario. This makes life difficult for commercial banks, as they get charged a negative interest rate (effectively a fee) on their deposits held at the central bank but can't pass this on to retail savers for fear of deposit flight. As a result, negative rates merely act as a tax on bank profitability. In fact, the policy could prove counterproductive if banks respond by raising loan charges or fees, or, even worse, reducing lending.

The Swiss central bank is at the forefront of negative rate policy with a policy rate currently set at -0.75%. So far, banks have not generally passed this on to consumers—the average interest rate on savings accounts (typically used by households) has not fallen below zero. Some Swiss banks have recently announced that they may start charging their wealthiest clients to hold large deposits later this year, although this remains far from mainstream practice.

Banks have more flexibility in passing through negative rates to corporate customers because it is impractical, if not impossible, for companies to hold their cash in physical form (they would need much bigger mattresses). This is evidenced by the decline in interest rates paid on the one-month term deposits that are predominantly used by corporations rather than households (see **Exhibit 2**).

EXHIBIT 2: SWISS POLICY RATES AND INTEREST RATES



Source: Swiss National Bank (SNB), Refinitiv Datastream, J.P. Morgan Asset Management. Prior to 2015, the SNB policy rate refers to the midpoint of the SNB's target range for three-month LIBOR. Data as of 22 August 2019.

Central bankers are cognisant of the issues that negative rates cause, particularly for the banking sector, but have so far decided that the net impact is positive. At some point interest rates will be so low that the benefits no longer outweigh the shortcomings; this is known as the "reversal rate".

One strategy that attempts to mitigate the impact of negative rates on the financial sector is known as "tiering". When tiering is applied, commercial banks are only charged negative interest rates on a portion of their reserves held at the central bank, with a higher (or less negative) interest rate being applied to the remaining portion.

Tiering is already being employed in Switzerland and Japan. The European Central Bank has publicly stated that it is actively considering the strategy as a future option, which has helped to push down the market's perceptions of how low eurozone interest rates can go. However, in the case of Japan and Switzerland, tiering has only served to dampen, not remove, the negative impact on bank profitability.

One radical solution would be to move to a completely cashless society, which would enable banks to pass negative rates directly on to households without having to fear capital flight. Such an approach would be extremely controversial politically, but as in the case of the "crazy" financial analyst predicting sub-zero interest rates, nothing should be ruled out in the future.

What is the impact on savers and investors?

A world of negative interest rates is a bleak environment for risk-averse savers, who are being starved of low-risk income from traditional sources.

Investors should not abandon the principle of no risk, no return. But for those willing to tolerate a degree of capital volatility and/or illiquidity there are options to maintain income. Higher-yielding corporate debt or emerging market debt offer attractive income, but screening on quality is important with a focus on avoiding overly-leveraged issuers who could be most sensitive to a stall in global growth.

Similarly, higher-dividend paying equity benchmarks may also be appropriate for those with longer time horizons who can cope with a degree of capital volatility. In an equal weight equity/bond portfolio, stocks now generate around 80% of the income for a sterling investor and 100% of income for a euro-based investor (see **Exhibit 3**). From a regional standpoint the FTSE All-Share is one of the highest dividend-paying equity indexes, although Brexit uncertainty currently complicates the decision to allocate to UK stocks. For investors that are able to tolerate an element of illiquidity, infrastructure assets also warrant consideration as a reliable source of income.

In Europe at least, the long-term prognosis for cash returns looks bleak. Long-term planning, and an understanding of the different risks inherent to different asset classes, is essential for savers to reach their investment goals.

EXHIBIT 3: PROPORTION OF INCOME GENERATED BY EQUITIES IN AN EQUAL WEIGHT EQUITY/BOND PORTFOLIO

Source: Bloomberg Barclays, FTSE, iBoxx, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. The lines represent the proportion of total income generated in a portfolio of 50% equities, 50% bonds. For sterling investors, indexes used are FTSE All-Share and iBoxx £ Overall. For euro investors, indexes used are MSCI Europe ex-UK and Bloomberg Barclays Euro Aggregate. Equity income is based on dividend yields. Past performance is not a reliable indicator of current and future results. Data as of 22 August 2019.

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