FAQ: COVID-19 and Negative Interest Rates

All assets have been impacted by COVID-19 and the global effort to contain the virus. The potential rise of negative interest rates and their implications have surfaced as top concerns among investment professionals and from our clients. For many investors, the notion of negative interest rates seems counterintuitive, even in extraordinary circumstances.

1919 Investment Counsel addresses your questions on the logic behind negative interest rates and the likelihood we will see them in the U.S.

What are negative interest rates?

Negative interest rates are effectively a "tax" on savings. A negative rate environment drives investors and savers alike towards investing and spending, because there's less incentive to save. In fact, investors that choose to place their money in a very safe investment such as government bonds are penalized in the form of negative rates—they are paying for the safe keeping of their money, not unlike rental cost for a safe deposit box. The policy goal of negative interest rates is to encourage lending and investment, by making "the cost of money" very inexpensive for borrowers.

Negative interest rates have been a fact of life for some time in places like Europe and Japan, as we have discussed in previous reports (see: The Curious Case of Negative Rates). Today, there are over $11 trillion in negative yielding securities worldwide[1]. Although this is down from the peak of over $17 trillion in late 2019, it still represents a very large amount of global debt at a negative yield. For example, the entire German yield curve is in negative territory, with German 10Y bund currently yielding -0.52%.[2]

How likely are we to see negative interest rates in the U.S.?

In March 2020, short term T-bill rates were negative for a few days before crossing back to positive. This brief episode was not a deliberate policy decision. Rather, it represented a confluence of events from the onset of the COVID crisis: a spike in demand for very short-term risk-free assets, and technical pressure from large market participants covering short positions. These issues have largely been resolved, and U.S. Treasury rates across all maturities are currently positive. Although we note that Fed funds futures are now pricing in negative rates beginning in April 2021, we believe this is another market anomaly and not indicative of future Fed policy.

We believe that we will not see policy-driven negative interest rates in the U.S. for several reasons. The Fed has been consistent in their stance that negative interest rates are not an appropriate policy tool for the U.S. Their concerns include the potentially destabilizing impact on money market funds and the negative effects on the banking sector. There is even a question as to whether the Fed can legally impose negative rates on reserve deposits.

[1] Source: Bloomberg
[2] As of May 11th 2020

The real answer to the question of whether rates in the U.S. will go negative may be straightforward. Federal debt is set to reach record-breaking levels, and the government will be issuing several trillion dollars of Treasuries to fund this debt. Given this upcoming Treasury tsunami, we believe that U.S. rates will likely stay positive in order to attract sufficient investor demand.

That said, former Fed Chair Bernanke has suggested that negative rates should not be ruled out as a stimulative policy tool. We are not ruling out the possibly entirely, but we believe the Fed will steer clear of negative interest rates for as long as possible.