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COMPREHENSIVE WEALTH MANAGEMENT

Thought for the Week (303):

Move Over ZIRP, Welcome NIRP

Synopsis

- The Fed has maintained a Zero Interest Rate Policy (ZIRP) since the financial crisis of 2008, and the European Central Bank (ECB) recently announced a Negative Interest Rate Policy (NIRP).
- A bank that offers a negative interest rate actually *charges* their customers to keep money with them, a rather counterintuitive business practice.
- The goal of NIRP is nearly identical to ZIRP in that it is designed to spur economic activity by incentivizing banks to loan super cheap money to consumers and businesses.

What Is a Negative Interest Rate?

The Fed has maintained a Zero Interest Rate Policy (ZIRP) for over five years in order to help repair our economy from the damage caused by the financial crisis. The goal of ZIRP was to keep interest rates so low that companies would be enticed to borrow super cheap money to hire workers and grow their businesses.

Last week, the European Central Bank (ECB), which is the central bank for the Eurozone and analogous to our Fed, announced that they will be charging banks in the Eurozone a 0.10% interest rate to keep deposits with the ECB. Meaning, they have taken it a step further than our Fed and are actually *charging* banks to keep money deposited at the ECB.

NOTE: *Think of the Fed and the ECB as a bank for banks. Bank of America, Deutsche Bank, Barclays, J.P. Morgan, and other large banks use the Fed and the ECB much as we use a bank. They store large amounts of money, called reserves, at central banks and when they need loans they can borrow directly from them.*

In a normal world, banks pay depositors an interest rate and then loan these funds out to businesses and consumers at a higher interest rate for a profit. The bank's goal is to earn a "spread", which is the difference between the small business loan revenue of 5% and their cost to depositors of 1%. In this example, the bank would earn a spread of 4% on the total loan value (5% - 1% = 4%).

Therefore, if the small business loan is $1 million for 12 months, then the bank will earn 5% from the small business, or $50,000, and pay the depositors 1%, or $10,000. The total profit to the bank is then $40,000 ($50,000 - $10,000 = $40,000).

Simply put, a bank's goal is to get as many deposits as possible because the more depositors that a bank can attract, the more money they have available to loan out to collect that spread.

The rate banks pay to depositors also varies based on competition. If the economy is on fire, banks are anxious to loan money and will pay higher deposit rates to attract consumers. In our example, a bank may increase its deposit rate to 3% from 1% to attract new customers. However, if the economy is slow, then they will offer a lower interest rate because they are not loaning as much money out to small businesses, etc.

Since central banks act as banks for the banks that we use on a daily basis, the ECB is effectively telling European banks that they are going to start charging them to deposit money with the ECB. Imagine paying Bank of America to have the privilege of keeping your hard earned money on deposit with them!

Why Would the ECB Do Such a Move?

The ECB is now the first major global central bank to take interest rates into negative territory, and the reason for their decision is not unlike the reasons why the Fed has chosen to keep our interest rates artificially low.

Europe has experienced declining inflation while recovering from a deep recession for over two years. Currently, the ECB measures inflation in the Eurozone to be approximately 0.5%, which is far below the bank's goal of 2.0%.

As counterintuitive as it may seem, some inflation is actually a very good component to a healthy economy because it signals that demand for goods exceeds supply. Demand can only be high if the economy is strong and consumers and businesses are spending money.

Typically a central bank wants inflation in the range of 2.0% – 2.5%, but when inflation creeps above 3.0% they will almost always act to cool down the economy. Much like an engine, an economy can overheat and cause a long list of problems.

Now if inflation continues to decline towards zero, then an economy can succumb to the gravitational pull of "deflation". This is a scenario where prices for goods begin to decline, and as appealing as it may sound to pay less for goods, deflation is a very serious problem for an economy for three key reasons:

1. **Save Instead of Spend**: Consumers would rather save their money when prices are falling because goods cost less in the future than today. Given that consumer spending represents 70% of a developed country's economy, recessions can occur quickly when consumers stop spending.
2. **Debtors Get Hit**: If deflation is rampant in an economy, wages will also likely fall. Those consumers and businesses that must pay interest and principal on existing loans now have a bigger burden to face as their debt becomes more difficult to pay off since their interest payments remain fixed but their income is declining.
3. **Hard to Fix**: Deflation is a real problem because central banks have limited ability to fix a deflationary environment. Japan endured two decades of deflation until last year when their central bank finally took drastic measures to attempt to reverse course.

The ECB is acutely aware of the risk of deflation, and they instituted NIRP in order to prevent any further move in that direction. By charging banks to keep money deposited at the ECB, they are trying to incentivize these banks in the Eurozone to loan money to businesses and individuals.

Cheap loans should cause businesses to hire new workers and buy new machinery, and consumers can get cheap mortgages and loans to buy new automobiles, etc. As the demand for these goods rise, inflation should kick in and ease the threat of deflation.

Lastly, notice that although the policies are different between the Fed and the ECB, the goal is the same, which is to incentivize banks to loan money and spur economic growth.

Implications for Investors

Any policy designed to keep interest rates artificially low will continue this War Against Seniors and Savers. The world is so much more integrated today than even a decade ago, so what happens in Europe impacts investors here.

For example, European government bond yields have plummeted this year to levels close to where U.S. Treasury bonds currently reside. A few of these countries were at risk of default just two years ago, most notably Spain and Italy, and now markets are saying that these countries carry nearly the same default risk as the U.S.!

The bottom line is that the search for income has introduced a level of irrationality in markets that the Investment Committee feels is far too risky. Therefore, we continue to avoid investing in government debt because we feel that the risk/reward payoff is not favorable.

Furthermore, we do not anticipate Europe falling into a deflationary environment because the ECB has many more tools at their disposal if their NIRP fails to spark inflation. Although Europe is not as far along in their recovery as the U.S., they are moving in the right direction and the ECB will likely do whatever it takes to ensure the survival of the Eurozone.

Sincerely,

Mike Sorrentino, CFA
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