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March 2016

Recessions, Reactions and Negative Interest Rates

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The range of market returns – from the asset with the highest return to the asset with the lowest return – determines the potential range of investment returns. Every return comes from someplace in the market, and no legitimate return can exist outside the actual market returns and their amplifiers, such as leverage and derivatives. Investment success can only be relative to market results.

Market returns are in turn dependent on economic conditions, although they can be significantly out of sync with the economy at any particular moment. That is because market returns relate to actual economic facts, such as company earnings and interest rates, as well as the aggregate of investors' expectations about growth and the future economic climate. That is why investors pay attention to the economy and to economic trends. It is important to have a sense of what is actually happening, what investors as a whole think might happen and the possible actions and reactions of regulators and others charged with "managing" the economy.

Of course, the economy is hard to manage. It is somewhere between a force of nature, like the weather, and the expression of group will, like political sentiment or fashion. While there are objective drivers of the economy, there are also many non-objective factors that are equally important – think of terms like "malaise', "animal spirits", "consumer sentiment", etc. The economy both shapes and responds to human behavior, a notoriously hard thing to regulate, not to mention, understand.

Although the economy is hard to manage – and no system yet has proven fool proof in this regard – it is important to try, since an unmanaged economy can wreak long term damage on the economic prospects of societies.

Consider recessions (and we are still in recovery from the last, great recession of 2008, even while we are on the watch for the beginning of the next): growing academic research indicates that their effect can out last the period of recovery that follows.

A July 2014 paper by Laurence Ball of Johns Hopkins University available through the Center for Policy and Economic Research notes that textbook macroeconomic theory says that output should return to full potential after a recession. However, there is mounting evidence that deep recessions have highly persistent effects on output. He estimates that the Great Recession caused a loss of potential output of 8.4% on average, which has been almost as large as the loss of actual output. In the countries hit hardest by the recession, the growth rate of potential output is much lower today than it was before 2008.

That finding alone provides strong motivation for policy makers to intervene in recessions that are underway and to adopt policy stances that they believe will mitigate the effect of recessions to come. A laissez faire approach to the problem of recessions would leave a significant amount of immediate and long term economic damage to be overcome.

The two large sets of policy levers on the economy are the fiscal ones, such as tax policy, regulations and public spending; and the monetary ones, such as money supply and interest rates. Fiscal policy is largely the purview of Congress and the President; monetary policy is largely the responsibility of the Federal Reserve.

It will come as no news to any reader that the President and Congress have been largely deadlocked on any significant movement on fiscal policy and that the political branches have been constrained in their ability to act. Although Congress and the President did initially respond to the great recession with a package of legislation that authorized Federal stimulus spending and support for the financial sector, concerns about the growing federal deficit overwhelmed these policies. Regulatory reforms enacted subsequently have yet to be proven effective or not.

That left the Federal Reserve and monetary policy to undertake the remaining heavy lifting to right the economy and steer toward recovery. The Fed and other central banks have held interest rates at historic lows for an unprecedented period of time in order to boost the economy and bring down unemployment. In fact, the rate of return on short-term investments has been below zero for some time, with the cost of living averaging in the high 1 to low 2 percent range and nominal yields until recently pegged at .25%, for a real return of about -1.75% after inflation.

Central bankers have a problem, however, in that with rates near zero, there is no place to go to provide additional easing if needed now or in a future downturn. That has led central banks in Sweden, Switzerland, Denmark, the Euro Zone and now Japan to set nominal rates below zero, a policy move with actual and psychological ramifications that are profound and puzzling. It’s one thing to have the value of your investment eroded by a rate of return less than inflation; it’s quite another to see interest deducted from your account each month. The Fed has also discussed negative rates as a policy option for the future.

In fact, the rational actor might well prefer to keep his liquid assets in cash rather than a short-term investment with a deducted rate of return. That would yield an investment return of principal minus inflation, rather than principal minus inflation minus the negative rate of return. Central banks have taken this possibility seriously and are now exploring eliminating higher denomination bills to make the storage of cash clumsier and less efficient. Both the 500 Euro note and the 100 dollar bill have been targeted for retirement in some policy discussions. There has also been some preliminary talk about creating a cashless system entirely.

The heart of the matter is that the negative rate is meant to push money out of savings and into the economy to stimulate growth either through investment or spending: storing money as cash defeats that purpose; making cash a less efficient storage vehicle or not available for storage at all supports that purpose.

Needless to say, these are extremely disturbing and controversial ideas. The good news is that existing and proposed negative rates really only effect mandatory deposits by banks at their national central bank. A future move would be to make them apply to big institutional and corporate depositors as well. Very far away is the idea that they would apply to individual investors in retail banks, although restrictions on cash transactions would presumably have big impacts at the retail level and across the board.

An obvious solution to all of this is to take the pressure off the monetary levers as the sole regulators of the economy and to rely on fiscal policy to do some of the needed work as well. Tax reform, regulatory reform and a rational plan for public spending on needed items for the common good, like infrastructure repair and improvement, could also go a long way to providing meaningful, long term and sustainable economic support.

In the meantime, the reality will be a near future of continued suppressed interest rates, even if the Fed is able to modestly increase yields throughout the year. Rather than chasing yield, PMA will continue to rely on a total return approach to maximize risk adjusted returns within a difficult and challenging market environment.