Fixed Income Academy Special Report

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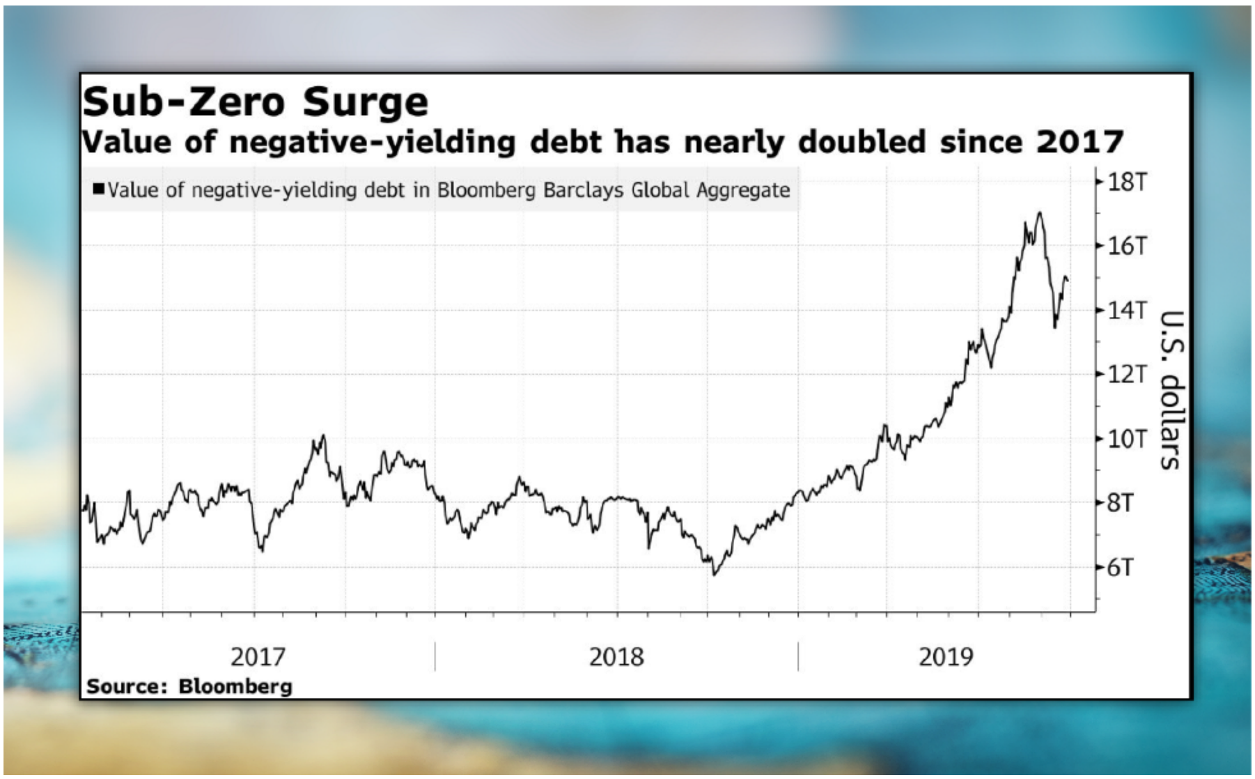
Negative Rates and Considerations for Public Agency Investors

By Parth Bhatt, Fixed Income Academy Advisory Board

There are approximately $16 trillion worth of sovereign bonds outstanding globally with negative yields today. Most of these are centered in Europe and Japan where central banks have maintained overnight lending rates in the negative territory to boost economic growth. The Federal Reserve's latest pivot from raising rates to making a complete U-turn and cutting them have many wondering when negative rates will arrive on American shores. The Fed usually cuts rates by at least 400 bps going into an easing cycle. Currently, the Fed Funds rate is at 2.00% – 2.25%; meaning the Fed does not have enough room to cut if this rate cycle happens to a secular move in rates and not a mid-cycle adjustment. Quantitative Easing is no longer considered an emergency measure, but a part of the Fed's normal recession fighting tool set, leaving many wondering what else the Fed can do to meet its policy mandate. Enter negative interest rates.



Negative rates bring with them a huge set of theoretical and practical challenges (maybe even legal ones). One of the most important theoretical assumptions of financial valuation is that risk-free interest rates should be positive. This hurdle rate determines the intrinsic value of how much one pays for financial or even physical assets. The world of money is governed by the gravitational force of positive interest rates. Throw that out of the window and you are in unchartered territory. The practical challenge of negative deposit rates is that the entire banking system is built (one could even argue that it is stable) due to the existence of positive interest rates. People deposit their money in banks because they expect to be paid and not charged for the privilege of having a bank hold onto their money.   Even if the banks choose not to charge depositors, getting penalized by the central bank's negative rates policy will effectively put the banks in slow liquidation mode. That cannot be good for any financial system. Extraordinary measures should provide extraordinary benefits. In the case of negative interest rates, the benefits are hard to see. If negative rates were going to rejigger growth in Europe and Japan, they already would have. The fact that such a drastic measure barely moved the needle in terms of growth is speaking volumes about its effectiveness. Bargaining the stability of the financial system in exchange for less than lackluster growth might not be a sound path.

This brings us to the legal challenges that negative rates will create. First, it is debatable whether the Federal Reserve's charter even allows it to charge interest rather than pay interest on deposits. There is little doubt that a measure this drastic will receive lots of legal scrutiny. But more importantly, this brings us to the legality of investing in a negative interest rate environment. In the state of California, local agencies are bound by statute that governs what they can and cannot do in terms of investments. Though the statutes are broad, they do have a subsection that explicitly prohibits local agencies from buying securities that result in zero interest accrual. California Government Code Section 53601.6 (b) reads in part, "A local agency shall not invest any funds pursuant to this article or pursuant to Article 2 (commencing with Section 53630) in any security that could result in zero interest accrual if held to maturity." The zero bound of interest rates is encoded here explicitly and legally. If interest rates go negative, it will present local agencies with a unique challenge. Undoubtedly, there would still be ways to construct portfolios as long as there are positively yielding instruments. California municipalities can purchase cash, medium-term corporate instruments, and government-backed instruments. To construct a portfolio that exclusively consists of corporate instruments would mean taking on more credit risk. Depending on how much of the maturity spectrum is yielding negative, the durations of portfolios will have to be pushed out to remain in compliance. The spirit of the California State statute for local agency investment is governed by safety, liquidity, and yield. If yields are negative, local agencies will be forced, at minimum, to compromise the safety and liquidity of the funds in their care.