Negative Interest Rates — What Does This Mean To You?

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Last week, I had a client meeting with a very nice couple (Let's call them Jack and Stephanie). In our meeting, Stephanie asked a very good question, "How would negative interest rates affect us?".

If you've been keeping up with the news on the global markets, or really if you've had your TV turned on at all over the last few months, you have likely heard the buzz about negative interest rates. The Bank of Japan, the European Central Bank and several smaller European authorities have entered into the unfamiliar territory of negative interest rates, and the Federal Reserve itself is taking a look into the implications of moving the US federal funds rate into negative territory as well. (Just a quick lesson on Europe and its banking system. The European Central Bank is the central bank for the euro and administers monetary policy to the Eurozone, which consists of 19 member states. However, there are 28 nations in the European Union; nine of them are not part of the Eurozone.)

Some of you may be asking, "What does this mean for my investments?"; Others may be asking, "What does a negative interest rate even mean?".

So, to start, let's talk about central banks. A central bank is essentially a nation's bank, that holds accounts for the commercial banks that consumers interact with. The central banks give those commercial banks the ability to move their consumers' money around from account to account on a daily basis. Here in the United States, the central banking system is run by Janet Yellen and our friends over at the Federal Reserve.

A negative interest rate is exactly what it sounds like. It is interest charged by a central bank, rather than given by a central bank. In other words, with negative interest rates, a commercial bank must pay the central bank for the benefit of parking cash with the nation's central bank reserves. Think about this for a minute. The rationale behind this philosophy is that if a commercial bank needs to pay to store its cash, it would be motivated to lend any extra cash to businesses and consumers, thereby propelling the economy forward. The goal is to create a "use it or lose it" ultimatum, or, in this case, "lend it or pay for it.".

While the Fed has stated that conditions would need to get worse here in the US before they implement negative interest rates, the real question for many of us is, if they do, what does this mean for our investments?

So far, in the countries that have already instituted negative interest rates, there has not been sharp turnarounds in their economies. Economic growth in the Eurozone last year was 1.5 percent, better than the 0.9 percent recorded in 2014, but growth appears to be trailing off. In the fourth quarter of 2015 the Eurozone economy grew at an annualized rate of 1.1 percent.

From a global perspective, negative interest rates can negatively affect the value of currency in the countries where they are instituted. For example, with the European central banks making this move, euro investors will likely try to move money to countries where interest rates are higher, such as the US and other countries with positive rates. When they do so, they sell euros and buy dollars. When other countries see this, such as Switzerland who is not a part of the Eurozone, their central banks will possibly want to keep their Franc from gaining on the value of the Euro, will likely push their rates more negative. Let the cycle of rate cutting and currency devaluation begin!

Taking it a step further, it is important to look at the effect of negative interest rates on specific asset classes as well. For example, what could these negative rates do to equities? Negative interest rates should, in theory, function the same way that lowering rates to zero has since the crisis, benefiting stocks overall. But in practice, this unique round of stimulus may not be as rewarding for several reasons, a chief one being that the markets have been known to react not to a policy change itself but to how the policy change was announced and accepted by the public. For example, when the news hit that Japan instituted negative interest rates, the market reacted poorly.

The effect of a negative interest rate policy is more direct and more obvious for bonds. Taking rates negative is an indication that a central bank is concerned about a lack of economic growth. This will likely cause government debt prices to rise, while the yields will fall.

Folks, the true effects of negative interest rates remain to be seen, and that fact is likely a major concern in the eyes of the Fed as they consider their next move. The most important thing you can do is create an active strategy with your portfolio designed to take advantage of upward moves when momentum is on your side, while protecting against downward moves when momentum is not. You cannot just sit there and hold on for dear life.

Be vigilant and stay alert, because you deserve more. Have a great week.

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