BULL & BEAR BULLETIN

VALICENTI ADVISORY SERVICES, INC.

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ZIRP to NIRP

The financial markets have an alphabet soup of acronyms for different phenomena and metrics, specifically: ZIRP (Zero Interest Rate Policy) and NIRP (Negative Interest Rate Policy). ZIRP was originally a thing of imagination and NIRP was certainly not even considered. This was true until Sweden enacted a negative rate on deposits in 2009. The European Central Bank (ECB) followed suit in 2014. These measures were aimed at only deposits, thinking that people/consumers would go out and spend rather than lose money on money sitting in a bank account; however, the desired effects weren't truly realized and a new trend developed. Starting at near $0 in negative earning bonds in 2013, the world now has about $15 Trillion of negative yielding debt[1]. That means the owners of $15T in debt have to pay the borrowers every year. Strange things, such as a bank in Denmark now issuing negative yielding mortgages, have started coming from this policy. What's even stranger is how investors are viewing the role of money and future prospects. What are people thinking and how did we get here?

There's, of course, a mathematical way of getting to negative rates and why it might work (negative time value of money), but to quickly have an understanding of why it's occurring, it's best to look at the situation qualitatively. First, the world population as a whole is getting older and approaching retirement. According to World Bank data, almost 5% of the population was over the age 65 in 1965 and now it's almost 9%. As people get older, the investing philosophy is to reduce risk, i.e. buy bonds. As the entire world is doing this and chasing yield, rates are pushed lower and lower via more buyers. Some markets don't have the liquidity to withstand these kinds of purchases, therefore, prices are pushed higher and their rates are pushed down even faster than the rest of the world. Additionally, some financial institutions just need to have sovereign bonds as collateral, which creates even more buyers.

International investors are looking at their current markets and deciding how to rationalize NIRP, but what about the United States? At the end of July, the Fed (Federal Reserve) reduced the federal funds rate by -0.25% to 2.25%. The rest of the Treasury curve, set by the open market, is almost all below this, with the 30 year intermittently jumping above and below the upper range of the Fed Funds. The market expects more rate cuts, and, compared to other developed countries, the U.S. Treasuries provide the highest currency unhedged yield. The Fed also mentioned that this was an insurance measure against forces outside of the U.S.

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Sovereign rates are determined by a host a variables, like GDP growth and inflation, but will the U.S. see ZIRP again? Will the U.S. ever see NIRP? NIRP, at least on short-term borrowing rates, requires Congressional approval, which is unlikely. Other countries are already at negative rates though and starved for yield. With the U.S. looking like the best game in town, the bond bull looks likely to continue, but growth and inflation surprise in the international markets could move things fast and furiously.

[1] https://www.cnbc.com/2019/08/07/bizarro-bonds-negative-yielding-debt-in-the-world-balloons-to-15-trillion.html