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Uncommon Sense

First, Do No Harm: The Monetary Policy Cure Is Killing the Patient

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"Businesses and households react to lower rates by investing and spending more. Lower rates also support the prices of housing and financial assets such as stocks and bonds."
— Jerome Powell

Weird Science

Physicians are required to take the Hippocratic Oath, "First, do no harm." Evidently, there is no such oath for central bankers. The prescription for lower interest rates, and now in too many instances, negative rates, isn't the remedy for what ails the global economy. On the contrary, low and negative rates just might be killing the patient. Just ask Japan or, more recently, Europe. Similar to chemotherapy and radiation, zero and negative rates aggressively attack the powerful cancer cells of subpar economic growth and below-target inflation, but with harmful side effects. And although at times it seems as if the treatments are working, the global economy cannot be described as fully cured from the disease.

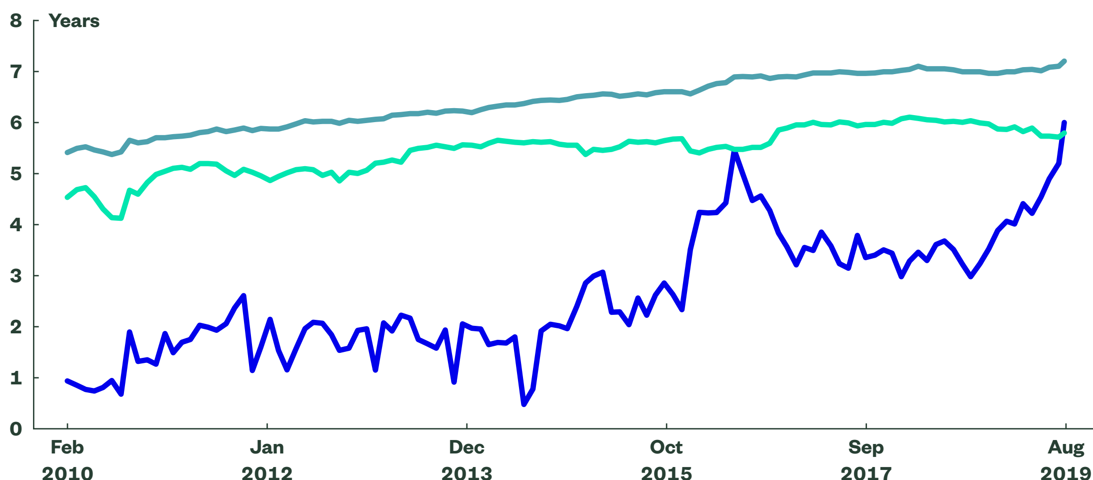
Everyone has conveniently, and seemingly all at once, abandoned the belief that positive real interest rates are an important signal for a healthy economy. They provide a powerful hurdle rate discipline to corporate executives making long-term spending decisions and also deliver compelling incentives for savers. From my perspective, zero and negative interest rates are symptoms that still diagnose the global economy as sick more than a decade after the Great Recession. Unfortunately, that is not the view of the current Federal Reserve (Fed) leadership or, quite frankly, anyone else.

Check the Warning Label

The comment from Fed Chairman Jay Powell that opens this month's article doesn't tell the whole story. Yes, in response to low rates, US consumers have held up their end of the bargain by spending massively. And, financial assets — stocks, bonds and real estate — have soared. But Chairman Powell neglects to mention all those nasty little side effects from the zero and negative interest rates. Businesses have greedily stuffed their collective fists deep into their pockets, refusing to spend a dime on almost anything but repurchasing their own shares. Borrowing by both consumers and businesses has surged — piling up even more debt on top of an already huge mountain of debt. Low rates have penalized savers, hurt the banking industry's profitability and resulted in growing wealth and income inequality. Potential asset price bubbles may also be forming. Look no further than the nearly $16 trillion in global debt with negative yields.[1] The bull run in these bonds has been so spectacular that buying now and holding on until maturity guarantees the investor future losses. Yet, investors enthusiastically buy more!

Sadly, to the dismay of Chairman Powell and many others, zero and negative interest rates haven't done much to permanently repair sluggish economic growth or reignite inflation. And yet they continue on the same path, making the central bankers' motto, "If at first you don't succeed, try, try again!"

Figure 1
Negative Yielding Debt Duration Spikes



Bloomberg Barclays Global Agg Negative Yielding Debt Index Duration
Bloomberg Barclays US Agg Index Duration
Bloomberg Barclays Global Agg Index Duration

Source: Bloomberg Finance, L.P., as of August 19, 2019.

The Placebo Effect

How can President Trump and so many economists be certain that lower rates are the solution to the US economy's challenges? That policy hasn't worked for Japan. It hasn't worked for Europe, either. For example, today, the deposit rate of the European Central Bank (ECB) is -0.4%. The deposit rate is the interest rate that the ECB pays for deposits that banks hold at the central bank. It has been negative since June 2014. This means that banks have to pay for the balances they keep with the ECB. Will lowering the deposit rate to -1% revive Europe's stalling economy and save its failing banking industry? I doubt it.

But many remain convinced that zero and negative interest rates will boost growth and bolster inflation. Where is the evidence to support that claim? Proponents of zero and negative rates argue that the economy would be much worse without them. But, how do they know that?

In the US, the lower-rate crowd's faith is fueled by the following: The Fed's target funds rate is among the highest policy rates in the world and, therefore, should be lowered to improve competitiveness with other countries. The Fed's preferred inflation measure remains well below the 2% target. Economic growth has slowed everywhere, including in the US. Uncertain trade policy outcomes have increased recession odds. And, finally, the Fed has tightened too much by raising rates throughout 2018.

However, an equally compelling case can be made for keeping rates steady and at still very accommodative levels. Taking a simple average of GDP for the first two quarters indicates that the US economy is growing at 2.6%. As of August 16, the Atlanta GDPNow forecast estimates economic growth of 2.2% for the third quarter. These GDP numbers may be underwhelming, but they hardly suggest that the US economy is on the brink of recession. Moreover, the Bureau of Labor Statistics (BLS) reported in an August 13 news release that the core Consumer Price Index (CPI) that excludes volatile food and energy prices climbed 2.2% over the past 12 months, modestly above the Fed's inflation target. The latest BLS employment data also implies a strong labor market. The unemployment rate of 3.7% is near 50-year lows, and wages grew by 3.2% year over year.

Both the Institute for Supply Management measures of manufacturing and services for July are greater than 50, demonstrating that the US economy continues to expand.[2] The National Federation of Independent Businesses Small Business Optimism Index came roaring back, with 7 of 10 components advancing in July.[3] The Commerce Department says retail sales rose a healthy 0.7% last month, after a 0.3% gain in June. Online retailers, grocery stores, clothing retailers and electronics and appliance stores all reported strong gains.[4] Finally, US stocks remain within spitting distance of all-time highs. So why on earth is the Fed cutting rates?

The Fed's midcycle rate cut was a preemptive strike to protect the slowing US economy from Trump's damaging trade wars. Heavily export-reliant economies, such as Germany and China, are suffering through the uncertainty surrounding future trade agreements. And, even though it's never happened before, concerns were growing that slowing global economies would infect the US with a recession.

Powell's July rate cut was also an indirect swipe at the president's controversial approach to trade policy. Now, in a strange twist, President Trump and Chairman Powell have begun playing the blame game. Each claims their policies can't be successful without some help from the other person. Trump has been bashing Powell almost daily. The president claims that the US economy is winning big time as a result of his administration's policies, and if the Fed would just do its part by aggressively slashing interest rates, the economy would soar even higher.

Meanwhile, amid the growing chaos, the White House is reportedly examining proposals to bolster the economy with additional fiscal stimulus, including more tax cuts. All this noise can distract us from dangers of the Fed's monetary policy medicine. Reading the zero and negative interest rates' warning label more closely reveals that weak business spending and nauseous savers are likely harmful side effects.

Feeling Weak in the Knees

Digging deeper into the second quarter GDP data confirms that the US consumer continues to be the workhorse of the economy; personal consumption expenditures rose 4.3%, the largest increase since the fourth quarter of 2017. Government consumption expenditures and gross investment also increased, rising 5%, the fastest pace in a decade. Yet disappointing business spending remains a headwind to better economic growth rates. Gross private domestic investment tumbled 5.5%, the worst decline since the fourth quarter of 2015, as spending on structures slumped 10.6%. This decline pulled a full percentage point from the second quarter GDP number.

Market watchers quickly concluded that business spending was constrained by rising trade tensions between the US and China. It seems reasonable that uncertainty about the future rules of engagement would cause businesses to reduce their spending. However, business spending has been persistently weak throughout the long economic expansion — way before trade tensions between the US and China. Wait, I thought zero and negative rates were going to help bolster corporate executives' animal spirits? Actually, we're seeing the opposite effect. Corporate executives have become complacent and risk averse. Growing trade conflicts are only intensifying those feelings.

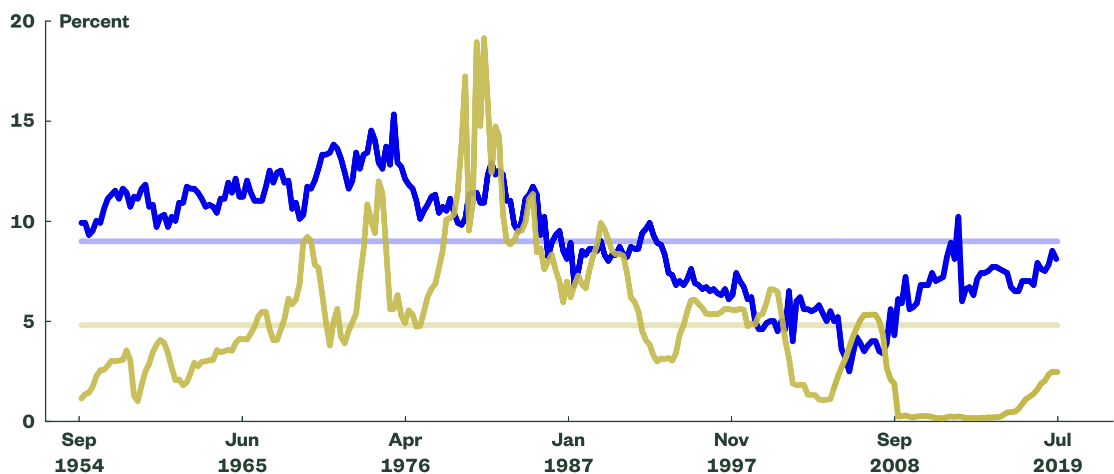
How corporate executives are spending unremitted corporate cash flows underscores this point. They only have a few choices: buy back shares, pay dividends, retire debt, pursue mergers & acquisitions, make capital expenditures, increase wages/hire more workers or save for a rainy day. In a zero and negative interest rate world, the easiest and safest choices are to buy back shares, pay dividends and save for a rainy day. On the other end of the spectrum, companies with weak business models can take advantage of low rates to borrow heavily. Their day of reckoning, and possibly ours, will come when interest rates finally rise, denying these fragile businesses access to the credit markets.

Reduced business spending, a harmful side effect of zero and negative rates, depresses productivity and weakens economic growth rates. Positive real interest rates provide a healthy hurdle rate for corporate executives' long-term investment decisions. Without them, expect executives to continue to make the safest and easiest choices when it comes to capital allocation. That means weak business spending will likely remain an albatross around the neck of economic growth.

Figure 2
US Savings Have Declined Alongside Interest Rates

US Personal Savings as % of Disposable Income

Fed Funds Rate



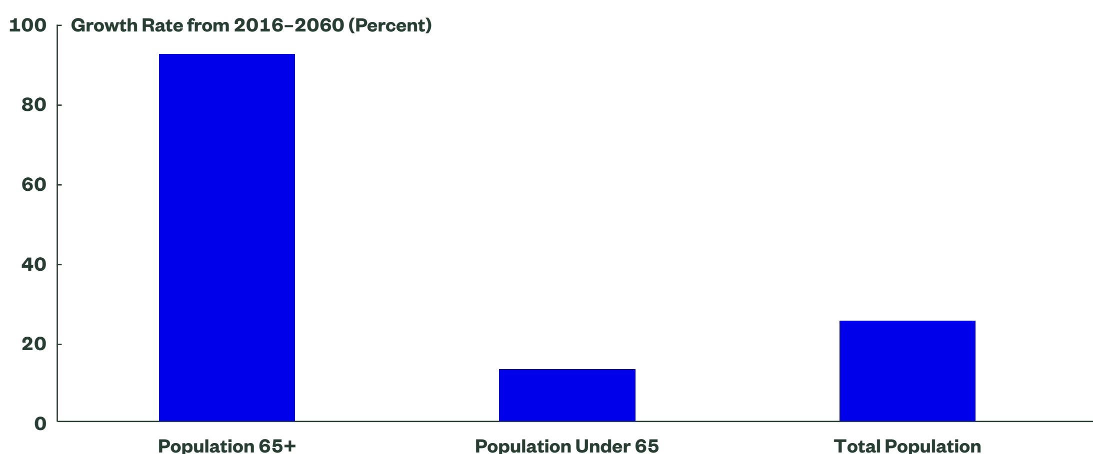
Source: Bloomberg Finance, L.P., as of August 19, 2019.

Someone Call a Doctor

Zero and negative rates are also destroying cash. When the Fed and other central banks push interest rates to zero or even negative in some instances there are clear losers. Low rates make it harder for savers to get a competitive return that might provide some financial independence today and a secure retirement in the future. In her August 19 *Financial Times* article, Karen Petrou brilliantly outlines the pain of cash investments in a low rate environment. She writes, "Assume you save $2,000 a year over 20 years at a 5% compound rate of interest. At the end of these two decades, in real (inflation-adjusted) terms, the saver will have earned $49,598, assuming a 2% annual inflation rate. As a result, the $40,000 in savings will have grown by $9,598. An attractive 24% increase. Now take that same $2,000 over the same 20 years and the same 2% inflation rate. But instead the saver only receives 0.5% compound rate of interest. In real terms the saver will end up with only $30,120. After taking into account inflation, the saver has lost nearly 25%. Finally, let's assume rates are negative, which many are now forecasting could happen to US interest rates — let's say -0.5%. The saver has now lost 29%."[5]

There was a time when simply rolling over Certificates of Deposit (CDs) at competitive interest rates was an attractive, conservative investment strategy for retirees. Sadly, those days are long gone, at a time when more than 43 million Americans, 13% of the population, are retired and receiving monthly payments from Social Security. Demographics in the US have shifted dramatically. The GIs who came home from World War II to rebuild the country, start families and live the American Dream were a decades-long catalyst for exceptional US economic growth and rising inflationary pressures. Now, however, the number of Americans retiring each day has nearly doubled since the year 2000. According to Deutsche Bank research, each day roughly 10,000 Americans turn 65, the standard age for retirement. Census forecasts find that number will reach nearly 12,000 in the next 10 years. By 2030, according to the Census Bureau, all Baby Boomers will be older than 65.[6] Positive real rates could really help America's fastest growing cohort. And advancements in medicine and longer lifespans together with greater income from positive real interest rates could result in an unexpected boom in their consumption that could increase economic growth. Ever see Ron Howard's 1985 film, *Cocoon*? Perhaps retirees earning a healthy retirement income could provide a boost to the economy.

Figure 3
By 2060, the Number of Americans Aged 65+ Will Double to More than 94 Million



Source: US Census Bureau, 2017 National Population Projections.

Bloodsucking Leeches

Just think about all the crazy medical treatments that have been used to cure the ill throughout history. For example bloodletting, the process of withdrawing vast quantities of blood from the body, was used until the late 19th century to cure just about anything. Today, we scoff and laugh at these wild remedies. Perhaps someday we'll all have a good laugh at how politicians and central bankers tried to use negative interest rates to heal the economy and spark inflation. Zero and negative interest rates are symptoms of an economy that's still sick.

I'll let you in on a dirty little secret. You know who needs zero and negative rates? Politicians do — to keep interest rates low on massive amounts of government debt and empty promises on entitlement programs, like pensions, Social Security and Medicare. You know who else needs low and negative rates? Weak companies with poor business models and lots of debt. And so do overleveraged consumers.

We need to change our collective mindset and quit the feel-good addiction to ever-lower rates. Positive real interest rates are a sign of strength and health. We should all embrace them. Strong consumers and businesses don't need your low rates, Mr. Trump, Mr. Powell and Mr. Draghi. You can keep them. Positive rates denote strength, provide healthy hurdle rates for sound business models making thoughtful long-term investment decisions, and give savers attractive options and income. Only when we have positive real interest rates will we know that the economy is truly healthy and that the Great Recession is finally behind us.

Endnotes

1 Paul J. Davies and Patricia Kowsmann,, "Germany for First Time Sells 30-Year Bonds Offering Negative Yields," *The Wall Street Journal*, August 21, 2019

2 Institute for Supply Management, July 2019 Manufacturing ISM® *Report On Business,* August 1, 2019.

3 NFIB, July 2019 Report: Small Business Optimism Continues to Defy Expectations, July 2019.

4 CNBC, "US retail sales rose solidly in July in a sign of consumer optimism," August 15, 2019.

5 Karen Petrou, "Low interest rates hurt the poor and vulnerable," *Financial Times,* August 19, 2019.

6 Kristin Meyers, "Americans are retiring at an increasing pace," Yahoo Finance, November 21, 2018.

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Glossary

Bloomberg Barclays Global Aggregate Bond Index A flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers

Bloomberg Barclays US Aggregate Bond Index A broad base bond market index representing intermediate term investment grade bonds traded in United States.

Duration An approximate measure of a bond's price sensitivity to changes in interest rates.

Gross domestic product (GDP) A monetary measure of the market value of all the final goods and services produced in a specific time period, often annually.

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