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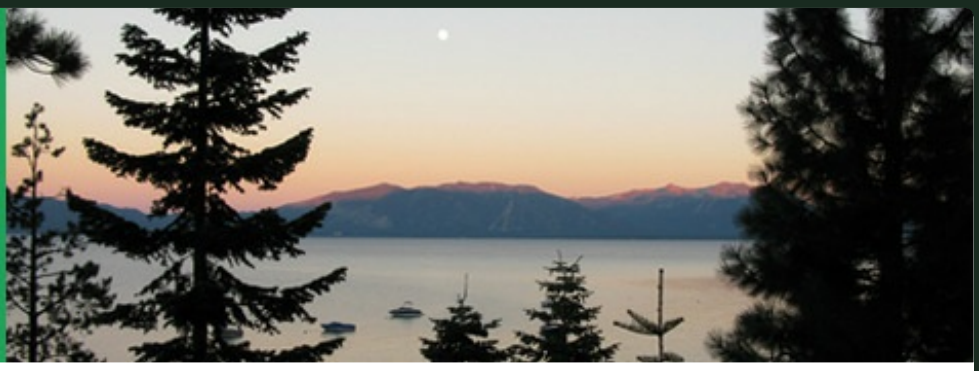


Central Bankers Accentuating the Negative

You may have heard the recent talk about negative interest rates and wondered what the world is coming to. Will banks and credit card companies soon be paying you interest on your outstanding debts?

Don't hold your breath, but several countries' central bankers, including Japan, Sweden, Switzerland, Denmark, and the euro zone, have decided that historically low interest rates just weren't low enough. They've gone negative, meaning that instead of their banks paying interest to depositors, they're charging them to safe-keep the money.

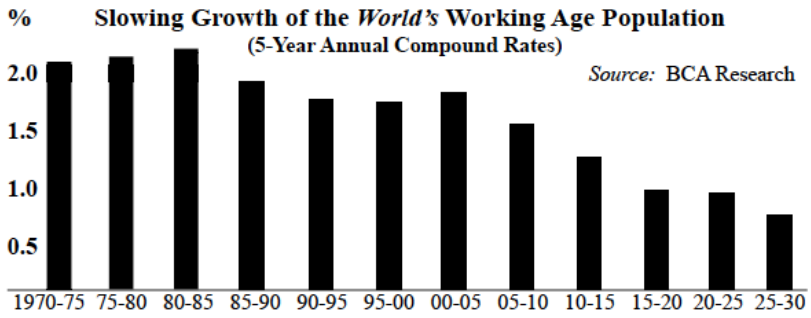
In the face of anemic economic performance and deflation fears, the objective is to further incentivize banks to write more loans at attractive rates, reduce the benefit of holding excess reserves, and boost loan related income. Negative short rates also lessen the appeal of a nation's currency which can help its exporters. And if investors are induced to step even farther out on the risk continuum, it can help support equity and bond prices.

All other things being equal, it sounds like a strategy. But those other things move too, and there's plenty of potential for unintended effects. Rates have been so low for so long that it's hard to see why nudging them into the red would suddenly ignite loan demand. Weak economic prospects appear to be a bigger factor suppressing loan demand and widening credit spreads.

Even if negative short rates can push bond buyers out on the yield curve, that might just flatten rather than steepen the slope, defeating the desired boost to bank profits. And currency-related effects on exports can be short-lived if competing countries decide to play the same monetary card.

In theory, interest rates (the price of money) should help rationalize the allocation of capital. Some economists contend that the long run of near-zero rates has fed a fair measure of misallocation. A lot of corporate borrowing has been used for financial restructuring, mergers, and acquisitions rather than to expand and modernize productive capacity. Perhaps not surprisingly, non-farm business productivity grew at an annual rate of just 1.2% for 2007 through 2015, matching 1973-79 for the weakest multi-year performance of the past 70 years.

Other powerful forces are at work. The economists at BCA Research point to one of them below: a pronounced, secular slowing in the growth of the world's working age population. The trend tracks from the opening years of the new century and appears to be baked in for at least the next two decades. Older households' tend to spend less and save more, which aligns with the theme of slack global demand. Prices for many goods are soft, and commodities are way down.



All that said, monetary policy remains the handiest weapon for the world's central bankers. It may seem that by now all creditable borrowers have had ample opportunity to finance their dreams and schemes at very friendly rates. We'll see whether promoting even more debt can help somehow.

Change in Store for Money Markets

For decades, money market mutual funds have been a staple of investor portfolios. An innovation of the 1970s, they pooled small investors' liquid reserves to access higher yields previously available only to institutional buyers of short-term corporate and government debt. That innovation helped drive banking deregulation, adoption of the universal IRA, and rapid growth in a wide range of retail financial services, all during an extended period of relatively high interest rates.

As the saying goes, the rest is history, including the 2008-09 financial crisis which illustrated the potential for a destabilizing "run" on such funds if they experienced liquidity strains. Since then the Securities and Exchange Commission has crafted new money market fund regulations which are to be fully implemented by this October.

As fund managers reposition for the new regs, individual investors will be looking to the newly defined "retail" and "government" money market funds for the kind of stable, free-in-and-out "cash" reserve we've been used to. These categories will be allowed to maintain that stable net asset value ($1.00 per share) using the amortized cost method or rounding to the penny.

The SEC defines "retail" investors as natural persons plus certain personal trusts, retail brokerage accounts, participant-directed retirement plan accounts, etc. The government funds must hold at least 99.5% in cash, government securities, and/or repurchase agreements collateralized by such securities.

These new regs will allow, and could require, a money market fund to impose limited redemption fees and/or a temporary hold if it faces liquidity constraints. However, stable net asset value and ready liquidity are a money market fund's stock in trade, so redemption fees or holds would only be invoked under real financial duress. The SEC's new rules are intended to make that even less likely than before.