Fed Funds futures are predicting that the Federal Reserve will lower their benchmark Fed Funds rate below zero by mid-2021. Will this really happen? Will COVID-19 be the crisis that settles all of those theoretical debates in economics class and on bank trading desks about whether it’s possible to have negative interest rates?[1] It is important to reframe any action, especially an unprecedented one, by reminding ourselves what the Fed is trying to accomplish with its monetary policy.

As a reminder, from a monetary policy standpoint, the Fed’s statutory mandates are maximum employment, stable prices and moderate long-term interest rates. Practically, this has been simplified into two major areas of focus for the Fed: inflation around 2% and low unemployment. Inflation, for the most part, is impacted most directly by consumer demand. The more people buy, the higher prices go until businesses decide to increase the supply of whatever is being bought (see your Microeconomics 101 notes from college in that box in your basement). As a secondary effect, the more businesses anticipate demand, the more they manufacture and buy raw materials. These two represent the most common economic measures watched by market participants: the consumer price index (CPI) and the producer price index (PPI). Taken together, they also basically constitute the gross profit component of a company’s income statement – revenues minus cost of goods sold.

Taking the three easier ones first:

1. In our view, US borrowing rates won’t go negative. This is an obvious statement, as no country or investor would pay the government to take their money right now. That said, rates are so low that maybe we are wrong. A scenario in which this could happen is if people lose faith in their depositary institutions and feel their cash is safer in treasuries. Even so, an SIPC-insured custodian holding bonds probably wouldn’t be perceived as much safer than an FDIC-insured custodian holding cash, so we would also expect people to ask for physical treasury certificates to put under their mattress instead. Who said paper was dead?

2. We don’t see retail rates going negative simply because banks want to make money and won’t pay consumers to borrow without some explicit government mandate to do so. However, it is unclear how that would work. The government is better off finding other ways to give money directly to consumers. As we will discuss later, going through the banks may not be the most effective way to accomplish this goal.

3. Lastly, we don’t believe negative LIBOR rates make sense, as those represent the rates set by banks in London at which they are willing to lend to one another. Much of this is discussed later when we discuss the Fed Funds rate, which is another intrabank rate and which has an impact on LIBOR. But, historically, where LIBOR has deviated from central bank rates has been in times of bank distress, where if anything, LIBOR can go higher to reflect an implicit credit spread in the rates at which banks are willing to lend to one another.

So in this commentary, we focus on central bank rates. While we don’t intend to imply that we know all of the answers, we hope to provide readers with a framework to form their own opinions.

Employment, on the other hand, is not always quite so directly impacted by consumer demand or the supply of goods as we are seeing today. Increased productivity and efficiency in a business often leads to redundant employees. Technology advances have led to many companies reducing their workforces, and it is unlikely this trend will stop (which, incidentally, was the primary driver behind Andrew Yang’s argument for a universal basic income). The resulting lower costs can spur demand further. Meanwhile, the newly unemployed are redeployed to find demand for their skills; develop new skills; or count on societal innovation to create new jobs in entirely new industries (e.g. gig economy), though these don’t always come with the same levels of income (e.g. gig economy). And in a period when profits are low, employers often expect...
fewer employees to do more work per person to maintain revenues and increase profitability.

Right now, the spike in unemployment is very clearly coming from an artificial reduction in demand (e.g. shelter-in-place mandates), which in turn will almost certainly lead to a natural reduction in demand (e.g. less or no income – less or no discretionary spending and more price sensitivity in non-discretionary spending). Meanwhile, asset prices, usually the consumer’s last resort source of cash, can come under additional pressure if the economy struggles to regain its footing.

So the challenge of policy makers is multi-fold: try to shore up spending and keep some base level of demand alive; try to motivate companies to keep people employed when they don’t want to or can’t; try to prevent people from mortgaging their future to pay for the present through a liquidation of assets; and try to motivate banks to lend to people, against the value of their assets if necessary, as a temporary means of liquidity.

If we look at the CARES Act and recent Fed actions, we see policies pointed at each of these goals. The $1200-per-person coronavirus stimulus checks are basically spending money, whether used on essentials or not. The Paycheck Protection Program (PPP) is a short-term incentive for employers to keep people on payrolls, though the two month window may prove to be overly optimistic with its assumption that, by the end of June, a resumption of demand for goods and services will justly keeping the same people on payrolls from a business standpoint after the government support runs out.[2]

Meanwhile, the Fed Funds rate cut, an expected move, is a typical tool in the Fed’s toolkit to make capital cheaper to banks, which in turn should (but does not always) make capital cheaper, or at least available, to borrowers, whether they are companies who may keep people employed or consumers borrowing directly through mortgages and other consumer loans. The Fed’s willingness to buy securities in the primary and secondary markets, an unexpected move, seems to have a dual purpose of keeping companies afloat so they don’t have to layoff entire workforces and also to shore up asset prices. We’d like to think that this was intentionally put in place as a defense of collateral to shore up lending, but in reality, that was probably just a lucky side-effect of an attempt to stave off widespread panic and to offset potential not-so-aligned behavior from the banks.

**Your Bank: When Free Isn’t Cheap Enough**

Despite the cheap money they have been offered, banks have their own reasons for not using that capital to lend. They appear more likely to act in a principal capacity as borrowers from the Fed to shore up their own balance sheets than to act in an agency capacity by passing loans through to other borrowers. To be sure, the banks are lending somewhat, but they are also being forced to make good on (and fully fund) existing lines of credit, which has hamstrung their ability to make new loans.

And let us not forget that the scars of 2008 are still present even as we have fresh wounds from 2020 that haven’t yet started to heal. The banks learned the hard lesson that liberal lending without better credit standards was not good business, no matter how cheap their capital might be. Principal losses to bad credits can overwhelm the profit margin of an entire loan book. Instead, making cheaper loans to already good credits makes better business sense to the banks. Furthermore, in 2008, the less affluent consumer, the socioeconomic demographic being most hurt in 2020, was painted as risky credit, and that paint has been stubbornly hard to wash off.

With this backdrop, the Fed is also acting to make direct loans (which is unprecedented) to corporate America. In our view, this is in part due to a lack of confidence that the free money they are offering the banks will trickle through to the companies they believe that money should be helping. They find themselves feeling compelled to make those loans themselves in a way that may or may not be allowed (there is some debate) but isn’t obviously illegal.

What then does the Fed accomplish by taking their Fed Funds rate negative? The Fed Funds rate is the rate at which the Fed targets that banks should borrow from and lend to one another. The Fed Discount rate is the rate at which the Fed lends directly to banks. This rate is generally higher than the Fed Funds rate to try to get banks to borrow from one another first. By guiding the intrabank rate lower (and using tools in their arsenal to adjust the money supply to try to make it so, such as repurchasing treasuries), the Fed is making it more (or less) attractive for banks to lend to customers instead of sitting on cash or just lending to one another. Low rates tell the banks that they should lend to customers because they will not earn much lending the same capital to other banks. Negative rates up the ante by telling them they will have to pay to lend to other banks.

But, as we have established, the banks' incentives are not necessarily aligned with using that money to lend, regardless of how low their cost of capital is. That said, they are not unaligned either. As discussed earlier, we do not believe (and we don’t think the Fed believes) that banks will make consumer loans to anyone they don’t think can repay. We do think, however, that banks are likely to more aggressively underwrite loans and bond issues from corporate America until defaults...
2016-2019 was a period of indiscriminate corporate lending for which the closest parallel (in our eyes) was the indiscriminate consumer lending before the 2008 financial crisis. This “no company can go under” mindset isn’t gone yet, though it has been narrowed to “most companies can’t go under” at the moment. But, the banks also earn significant fees from the underwriting, so with capital cheaper and no shortage of investors to whom they can syndicate the risk right now, we are seeing them using those low rates to increase corporate lending.

Notably, interest rates do not have to be negative for them to do so. With rates near zero, banks are plenty incentivized already, and unless they hold corporate America hostage to try to force the Fed to give them even more to justify loans that are already attractive to make, the Fed isn’t incentivized to push the Fed Funds rate negative for this reason. Given the Fed’s signals to the market that they will backstop some subset of corporate credit, and the market’s willingness to misinterpret this as a backstop of corporate credit in general, there is sufficient demand to incentivize the banks to continue to underwrite and syndicate bonds and loans without the need for a negative Fed Funds rate.

Your Currency: Weaker May Be Stronger

Meanwhile, the Fed’s mandate would benefit from putting money directly into the hands of consumers so they spend even in these difficult times, but the Fed Funds rate doesn’t accomplish that directly in the absence of consumer lending from banks. Right now, we think negative rates are unlikely to change the banks’ current mindset. Direct market intervention, especially in the mortgage markets, may be the Fed’s best chance at having an impact here, but really, this is probably best accomplished as a fiscal policy matter (i.e. Congress, not the Fed). Federal Reserve Chair Jerome Powell said just this in a speech he made at the Peterson Institute for International Economics in mid-May.

This leaves us trying to make a relative monetary policy argument for negative central bank rates. President Trump is fond of saying that the Fed is making the US less competitive globally because other central banks have already set negative rate policies. Putting aside the well-reported evidence that Europe does not appear to have a stronger economy as a result of negative rates for now, we will make a different point here to bring some context to the President’s claim. He is not necessarily entirely wrong, but in the current environment, this claim does not necessarily hold as much water as it might otherwise. And in all environments, the issue is much more nuanced anyway.

When a bank can borrow at a negative rate from another bank or a central bank, as we discussed earlier, that bank is expected to lend at low rates within its own economy. This represents a closed system if all money is sourced from and lent within that country’s (or economic union’s) borders. But the world is not a closed system. So, in reality, the other reason a bank might pay to lend capital is because the bank can borrow capital even cheaper (i.e. can get paid even more to borrow). This does not happen without capital coming from outside that otherwise closed system.

So, using Europe as an example, a bank might lend Euros at a negative rate to another bank because they believe they can borrow funds in a different currency and get paid more. Notably, the other currency does not have to also have negative rates for this to work. Even if the European bank had to pay to borrow the external currency, they might still win if they believe the external currency will weaken relative to the Euro, since it will cost them fewer Euros to repay the borrowed currency later even after taking into account the interest expense on both sides of the trade.

If the US dollar is that external currency, it is not clear to us that this expectation of a weaker dollar is a bad thing. While the US government may prefer to talk about a strong dollar for public sentiment and psychology, the weaker dollar means more competitive exports. It also means higher priced imports, which could cut both ways: more domestic manufacturing, but also higher prices on products that are still imported, albeit with potentially lower demand to keep prices in check anyway. Recent tariff disputes complicate this picture further, but it was good to see the Trump administration suspending tariffs temporarily in a nod to this issue.

Simply speaking, what we’re saying is that an arms race to lower rates may be counterproductive to a weaker dollar, which is not a terrible outcome if the Fed believes domestic industry plays a key role in helping them achieve their mandate. The demand drop right now might suggest that their employment mandate has more to gain than their inflation mandate has to lose.

Your Future: The Fed’s Self-Fulfilling Prophecy?

For all of these reasons, we don’t really see any incentive for the Fed to take rates negative, and they have been pretty clear that it is not on the table, even though the markets seem intent on ignoring them. Why? Because this Fed has also had some trouble ignoring the markets (and the President’s rhetoric) over the last two years. This may be disappointing to some, but it is understandable: The consequences of surprising the markets with reasonable policy was laid bare in 2013.
when then-Chairman Ben Bernanke suggested the Fed would begin to “taper” its quantitative easing program. Since then, it seems the Fed has adopted a new self-imposed mandate: avoid another “taper tantrum” shock. In fact, at a round table with both Mr. Bernanke and his predecessor Janet Yellen in January 2019, Chairman Powell himself said exactly this: “The taper tantrum left scars on anybody who was working at the Fed at that time.” His takeaway from that episode was that the Fed should clearly broadcast its thinking to the markets and be as predictable as possible.

But what if the markets don’t listen? This is where the uncertainty lies. If the market won’t expect what the Fed is guiding toward, the Fed may just end up doing what the market expects. And despite all of the arguments against a negative Fed Funds rate, if the markets are pricing it in, this unprecedented move is entirely possible. But this probably won’t be a decision grounded in monetary policy so much as public pressure. With an election year upon us, anything is fair game.

**Important Disclosure Information**

Zeo Capital Advisors is a fundamental investment manager to a short-duration credit mutual fund, a sustainable high yield mutual fund and separately managed accounts. Venk is the Chief Investment Officer and founded Zeo Capital Advisors in 2009.

*Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Zeo Capital Advisors, LLC (“Zeo”), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Zeo. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Zeo is neither a law firm, nor a certified public accounting firm, and no portion of the newsletter content should be construed as legal or accounting advice. A copy of Zeo’s current written disclosure Brochure discussing our advisory services and fees is available upon request. Please Note: If you are a Zeo client, please remember to contact Zeo, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. Zeo shall continue to rely on the accuracy of information that you have provided.*

1 When, discussing negative interest rates, it’s important to distinguish what one is talking about: US borrowing rates (e.g. Treasuries); retail rates (e.g. what individuals earn on instruments like deposits/CDs or pay on consumer loans); intrabank rates (e.g. LIBOR); or central bank lending rates (e.g. Fed Funds).

2 Congress acknowledged just that and extended the 8-week period to 24 weeks in a new bill passed on June 3.

© Zeo Capital Advisors