FINANCIAL
Insights

MARCH

Rates Go Negative

In mid-February, the Bank of Japan (BOJ)—Japan's central bank—lowered its funds interest rate to -0.1 percent. It meant the BOJ would begin charging private Japanese banks for holding on to excess cash reserves.

This negative interest rate policy (NIRP) is not unique to the BOJ. By "going negative," Japan joins the European Central Bank and the central banks of Sweden, Switzerland and Denmark.

Why are so many central banks doing this? Economic growth in several developed countries has recently slowed down as businesses have grown accustomed to low rates. Central bankers hope that pushing rates down into negative territory will help their economies resume expansion.

How it Works

To understand how NIRP is supposed to help, try imagining what would happen if your personal bank accounts had negative interest rates. How would you react to paying to save money each month? What changes would you make to your finances?

You probably would reach the same conclusion as most people: "I need to minimize the money in my accounts." One option would be to invest the money so that it has a chance to grow; another option would be to spend it on a major purchase before you need to pay any interest.

These are essentially the same responses governments are hoping to incite from investment banks and large corporations. Economic slowdowns cause businesses to focus on saving money when central banks need them to spend it. The savings penalty created by negative rates squeezes hoarded cash out of corporate accounts and into new business investments.

NIRP also provides a strong signal that a central bank will do whatever it takes to promote healthy inflation and fight against a slowing economy. This means a NIRP can become a type of rallying point for businesses, creating enough confidence in future growth that companies proactively expand and turn their growth expectations into reality.

Effects at Home

The BOJ's move to negative rates has raised questions about the future of America's monetary policy. In a world where several central banks have continued to lower rates, the United States has been trying to raise them. Economists and investors wonder whether America will be able to continue bucking the downward trend or if its rate hikes need to be stopped.

Rising interest rates often accompany economic success. Because the United States' economic recovery has drastically outpaced most other developed economies since 2009, it needed to start increasing its interest rates first. As its economy improves, its interest rates should need to be raised.

However, central bank rates must be compared to each other. Although the United States has only recently started raising rates, rate cuts in other countries have led some to believe that its *relative* rates are increasing too quickly. If the relative rates climb too much, the dollar could become too strong and other countries would stop buying U.S. goods, hurting the chances of further U.S. growth.

Will America Go Negative?

While anything could happen in the future, most experts currently believe U.S. rates will not go below zero. The U.S. Federal Reserve has said it studies negative rates and simulates them for bank "stress tests" but doesn't envision needing them. After years of aggressive quantitative easing and zero percent interest rates, it's unclear what new benefits negative rates would even provide for the U.S. economy.

It's also important to remember that countries can influence rates in both directions. As the world's two largest economies, the United States and China are in position to help stimulate other economies through trade. If their growth and consumption become strong enough, the world economy will improve and rates in other countries will be brought above zero.

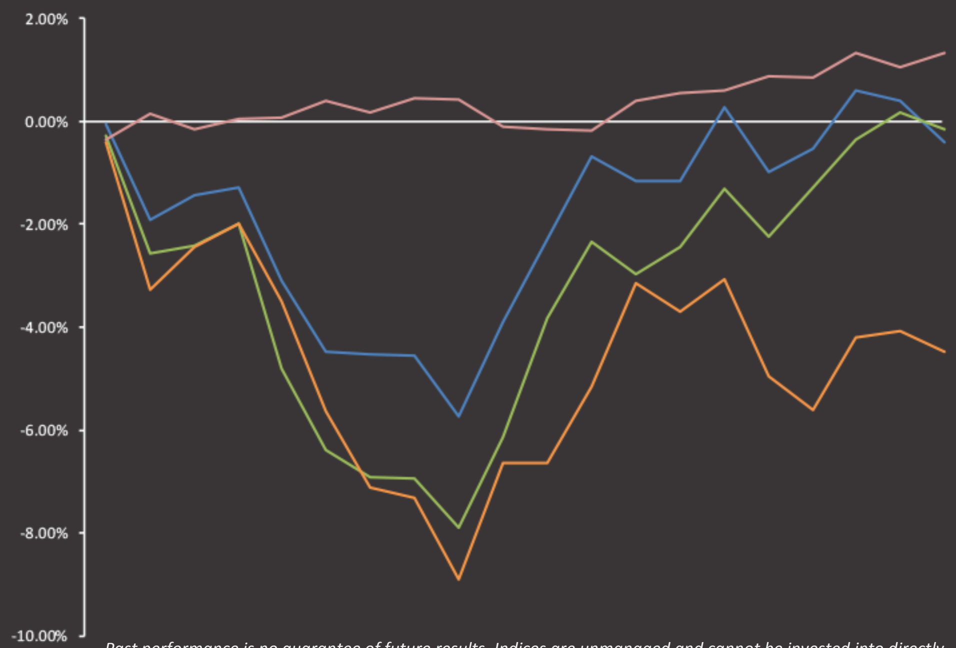
the market at a glance
FEBRUARY

U.S. Large Cap
(S&P 500)
1,932.23 (-0.41%) ▼

U.S. Mid/Small
(Russell 2000)
1,033.90 (-0.14%) ▼

International Large
(NYSE International 100)
4333.22 (-4.47%) ▼

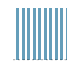
U.S. Bond Market
(Dow Jones Equal Weight U.S. Issued Corporate Bond Index)
347.84 (1.33%) ▲



Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly.

The market in action

- The U.S. Bureau of Labor Statistics reports that average hourly earnings rose sharply in January, increasing by 0.5 percent from the month before. Economists attributed the large jump to higher employment rates and new minimum wage laws in many states.
- Moody's Investor Service downgrades Brazil's credit rating by two levels, officially making its sovereign bonds "junk." Brazil had already received junk ratings from the other two credit rating agencies, Standard & Poor's and Fitch Ratings.
- Thanks to the 2015 surge in the Chinese stock markets, Beijing surpasses New York as the "Billionaire Capital of the World." Beijing is now home to 100 billionaires; New York has 95.
- The U.S. Department of Commerce authorizes Cleber LLC, a tractor company, to build a factory in Cuba. It is the first factory a U.S. business has opened in Cuba in over 50 years.
- After seeing its Q4 profits drop more than 90 percent year-over-year, oil giant BP announces plans to cut more than 3,000 jobs before the end of 2017. Nearly all major oil and gas companies have announced workforce reductions during the past few months as oil prices remain at decade lows.
- China announces plans to lay off as many as 1.8M coal miners and steel workers in an effort to reduce industrial overcapacity. While unable to provide a specific timeframe, Chinese officials said the process will take years.
- International Business Machines Corporation (IBM) agrees to buy Truven Health Analytics for $2.6B. It is the latest in IBM's steady acquisition of health-data companies as it works to improve the diagnostic capabilities of its "Watson" supercomputer program.
- Home-flooring producer Lumber Liquidator sees its market value tumble as the Center for Disease Control releases estimates showing that chemicals in some of the company's laminate flooring poses a cancer risk of six to 30 cases per 100,000 individuals. Lumber Liquidators stopped selling the contaminated flooring in early 2015.



Your Money with Greg Tull

Domestic and international stock markets have been volatile lately, and the weakness has been providing opportunities to rebalance portfolios by adding to equity holdings at lower prices in months such as August, September, January and February, especially for more aggressive clients. Taking a further look at the increased volatility over the past year or so, in 2015 the S&P 500 had six down months, including August 2015 that was down 6.1% for the month. (On average over the past 90 years, the S&P 500 is up about 0.75% per month, so negative 6.1% is a pretty big outlier). In contrast, 2012 had only 3 negative months, 2013 only 2 negative months, and 2014 only 4 negative months. There has also been upside volatility recently with the S&P 500 gaining over 14% from the low on February 11 through the end of March, after falling 11% from December 31 to February 11. Additionally, the stock market recently enjoyed its single biggest monthly gain of the past 5 years: up 8.5% in Oct of 2015. This close proximity of upside and downside volatility is not an unusual phenomenon. Big up and down days, weeks and months have a tendency to occur in fairly rapid succession since bargain hunters capitalize on the discounted prices that occur when panic sellers abound. The following article by Bob Veres, contributing editor and columnist of *Financial Planning* magazine, and past editor of the *Journal of Financial Planning*, *Investment Advisor Magazine*, and MorningstarAdvisor.com, further demonstrates why it is important for investors to be thankful for the "equity risk premium" and to embrace the degree of volatility that is commensurate with meeting their personal financial goals.

The Good Side of Bad Markets

After the recent downturn in the U.S. and global stock markets, you can be pardoned if you wished that the markets were a bit tamer. Wouldn't it be nice to get, say, a steady 4% return every year rather than all these ups and downs?

Be careful what you wish for. There are at least three reasons why you should hope the markets continue scaring investors half out of their wits.

1) The very fact that stock downturns scare people is one reason why stocks deliver a higher return than bonds. Economists call it the "risk premium;" which can be roughly translated as: people are not willing to pay as much for an investment that will periodically frighten them to death as they would pay for an investment that delivers a less exciting investment ride. Over their history, stocks have been a fairly consistent bargain relative to less volatile alternatives, which is another way of saying that they've delivered higher long-term returns than bonds and cash.

2) If you're accumulating for retirement by putting money in the market every month or quarter, every downturn means that you can buy shares at a bargain price while many other investors are selling out at or near the bottom. Over time, as the market recovers, this can give a little extra kick to your overall return.

3) Market downturns give an advantage to those who are willing to practice disciplined rebalancing among different asset classes. Basically, that means that when stocks go down, any new cash goes disproportionately into stocks to bring them back up to their former share of the overall portfolio. This, too, allows you to buy extra shares when the prices are low, and can also boost long-term returns. There's no question, the downward plunge on the stock market roller coaster is scary. It's hard to maintain your discipline when the voice in the back of your brain is telling you to bail out on the bouncy trip before somebody gets hurt.

But unless this is the first time in history that the market goes down and stays down forever, we will ultimately look back on the decline and see a buying opportunity, rather than a great time to sell and jump to the sidelines. The patient, disciplined, long-term investor should see market volatility as one of your best friends and allies in your journey toward retirement prosperity.

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