MERITAS ADVISORS

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Negative yields in our future?

Let's suppose somebody came to you with a proposal. You would lend this person $100 for a couple of months. Because this person was doing you the favor of keeping your $100 safe for a period of time, he proposes to only pay you back $95. In effect, he has paid you a negative interest rate for the privilege of lending him money. Or, put another way, you've paid him for the privilege of loaning him money.

What kind of obvious scam is that? It might surprise you to know that some of the world's largest banks are lending their assets under similar circumstances, and these are institutions you may have heard of: the Bank of Japan, the European Central Bank, and the state banks of Sweden, Switzerland and Denmark. Basically, they were taking deposits with a promise that the lenders wouldn't get all their money back.

Negative interest rates came on the global financial scene in 2016, and at the peak, some $12.2 trillion were loaned at negative rates. The negative rate concept evolved as a policy that would punish lending institutions for simply parking their money and earning interest instead of making the loans that would stimulate the economy. In theory, negative rates also reduce borrowing costs for companies and households, driving up demand for loans. But what if banks start passing on the negative rates to their traditional depositors, in effect charging them a fee in return for holding their cash (and lending it out, and profiting on it)? Customers would respond by simply putting the money in their mattresses instead, and generate a higher return (0%) than they would get at the bank.

The longest-running experiment with negative rates is taking place in Denmark, where two large financial institutions—Jyske Bank and Syndbank—now "offer" -0.6% on retail deposits bigger than $1.1 million. Over the last seven years, these and other banks have declined to pass these negative rates on to their depositors. The result is predictable. In July, Danish bank deposits equaled roughly $140 billion, which are then deposited in a central bank account at -0.60% or invested in negative-yielding securities. The banks are reportedly under financial stress that gets worse every year. It turns out (surprise!) that locking in a negative return on your investments isn't a profitable business.

Could negative rates happen here? The U.S. Fed sets rates at the short end of the yield curve, and they are currently a rather robust 2.25%—which means banks can simply park their cash and earn more than they would if they invested in 30-year Treasuries (an astonishingly low yield of 1.97% currently). If the U.S. experiences a recession, that rate will go down; how far will depending on how alarmed Fed economists become. In December 2008, at the bottom of the Great Recession, that rate came all the way down to 0.25%.

But it's worth noting that the Fed, this time around, would have to start its cuts from a lower initial rate, which means taking rates down to 0.25% won't have the same effect as they did in the last recession. If it were necessary to cut rates as aggressively in the next recession as the Fed did in the last one, that would certainly suggest negative rates in our future—and the U.S. would join a very big club around the world.

-Bob Veres

Sources:
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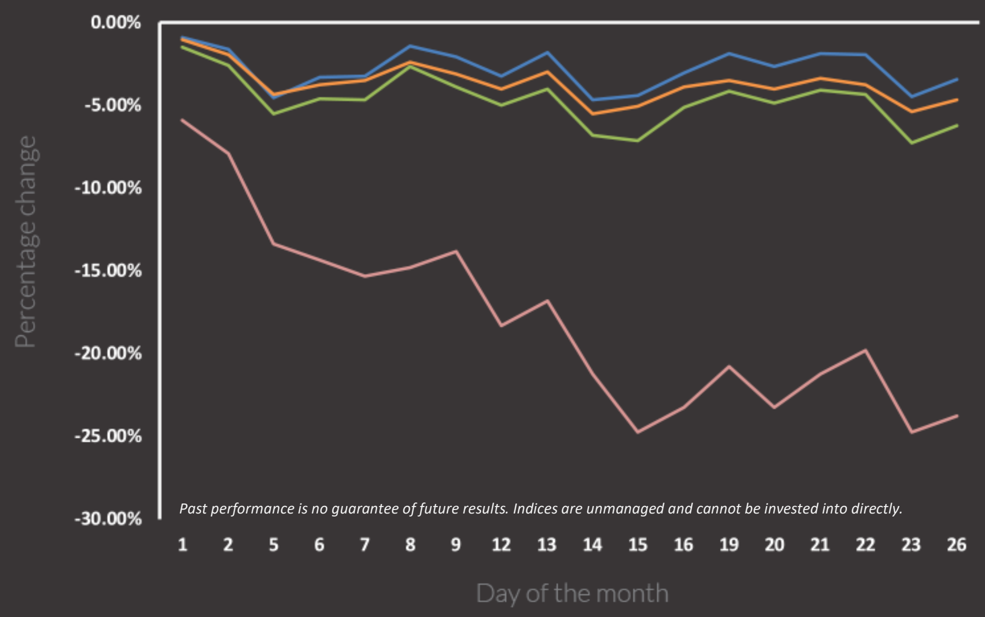
The market at a glance
August

U.S. Large Cap
(S&P 500)
2,926.46 (-1.81%)▼

U.S. Mid/Small
(Russell 2000)
1,494.84 (-5.07%)▼

International Large
(NYSE International 100)
5,271.12 (-2.95%)▼

U.S. Treasuries
(U.S. 10-year Treasury yield rate)
1.50 (-25.74%)▼



The market in action

- Shares of food manufacturer Kraft Heinz fell nearly 20 percent during August following a dip in sales for the 12th straight quarter. As grocery retailers like Walmart, Kroger, and Amazon have increased the production of in-house store brands, the company's stock has fallen by nearly 40 percent so far this year.

- Financial services and mobile payment company Square broke $1 billion in revenue in the second quarter of 2019, an increase of 44 percent since the same period in 2018. Following the report, Square announced the sale of its meal delivery service to DoorDash for $410 million. Despite the results, higher than projected losses led to a 15 percent dip in share price following the news.

- Luxury department store chain Barneys announced it is filing for bankruptcy and will operate just seven locations moving forward. The closure adds to the more than 7,000 total retail stores that have closed so far in 2019, a number that is projected to reach up to 12,000 by year-end according to Coresight Research.

- Transportation service company Uber reported its largest quarterly losses ever at $5.24 billion in the second quarter of 2019. Stock-based compensation associated with its IPO in May was a key driver for the losses, though its adjusted revenue has grown at the slowest rate so far in the company's history. Following the report, shares of Uber were down 10 percent.

The rise of **peer-to-peer payments**

Ask nearly any of today's college students how they split the bill for dinner, pay their roommates for cable, or even pay their rent and you will likely hear one common answer: Venmo. Peer-to-peer (P2P) payment services have exploded in popularity leaving many to wonder how bills were ever paid before them. Since just two years ago, P2P payment users have increased by 31.6 million users in the U.S. according to research from eMarketer.

How did this booming industry get started and who are the current big players? Let's take a look.

eCommerce payments are born

The origins of P2P payments can be traced back to 1998, when Cofinity launched as a financial transaction software company in Silicon Valley by founders Ken Howery, Luke Nosek, Max Levchin, and Peter Thiel. In late 1999, Cofinity would go on to launch its flagship product, PayPal. Noticing the potential of the money transfer business, Elon Musk, now co-founder and CEO of Tesla, facilitated a merger between Cofinity and his X.com business.

PayPal would go on to become the premier way to move money online. A key driver of PayPal's adoption was its integration with the popular eCommerce platform, eBay. Following its IPO in 2002, PayPal was acquired by eBay for $1.5 billion.

Over the following decade, PayPal would grow to more than 100 million active user accounts spanning 25 different forms of currency.

A forgotten wallet

As PayPal was gaining popularity, Andrew Kortina and Iqram Magdon-Ismail met as freshman roommates at the University of Pennsylvania. Their bond grew throughout college leading the two computer science students to work on several projects together in the years during and after college.

While attending a local jazz show, the two brainstormed the idea of being able to purchase a band's live set by sending a text message that would return an MP3 file via email. It was here that the name Venmo was created, a combination of vendere (Latin for "to sell") and mobile. During a weekend working on the music service idea in New York, Magdon-Ismail realized he had forgotten his wallet in Pennsylvania and would pay Kortina back via check for purchases made throughout the weekend. Quickly, the pair realized how inconvenient this solution was and that there was an unsolved need for quick and easy P2P transactions. Though PayPal was convenient for online purchases, its P2P functionality needed to be accessed via a computer. In a world where mobile was quickly emerging as the ideal platform for consumers, Kortina and Magdon-Ismail began pivoted their music purchasing platform to a P2P payment service that users would operate primary through SMS messaging.

The idea quickly appeared to be a hit. The Venmo co-founders would go on to raise $1.2 million of seed funding to develop applications for iPhone and Android users. Following its public launch in March of 2012, Venmo attracted the attention of payment system company Braintree, who would acquire Venmo for $26.2 million just over five months following the launch.

PayPal acquisition and Venmo today

Venmo continued its explosive growth among money-transferring millennials, but in 2013 its parent company Braintree was looking for a buyer. Coming full circle, PayPal acquired Braintree in late 2013 for $800 million, citing that Venmo was a key motivation to get the deal done.

Today, Venmo has more than 40 million active users that are on pace to transfer more than $85 billion through Venmo throughout 2019. Venmo leads several large banks in terms of digital users, outnumbering Bank of America's 37 million and Wells Fargo's 29.8 million. In fact, according to the Wall Street Journal, there is only one U.S. bank with a larger digital footprint than Venmo: JPMorgan Chase with 51 million users.

Venmo has also dipped into the physical payments industry with its Venmo card that allows users to use their Venmo balance by swiping a MasterCard-network enabled debit card at registers.

Cash App

Cash App is a competitor to Venmo that is owned by financial services company Square Inc. The service was created after Square fell short to PayPal in the acquisition talks with Braintree. The service operates with great similarity to Venmo in that users with the mobile app can send and receive payments to peers. It also offers a physical card, the Cash Card, for users to spend their balance at retail locations. To help compete with Venmo's card, the Cash Card offers promotional discounts called "Boosts" that give a certain percent or dollar off at specific retail chains or categories.

Despite doubling its number of active user accounts from 2017, Cash App entered 2019 with just 15 million users compared to Venmo's current 40 million.

Zelle

Big banks have certainly taken notice of the demand for easy P2P payments and in 2017 launched Zelle. The service is run by Early Warning Services, which itself is owned by Bank of America, BB&T, Capital One, JPMorgan Chase, PNC Bank, US Bank, Citibank, and Wells Fargo. With tight integration through these bank owners, Zelle places transferred money right into a user's bank account, not a separate balance like Venmo and the Cash App. Additionally, Zelle does not require users to set up an account if they are members at one of many participating banks.

Zelle has mounted a significant challenge in the P2P payments race and passed Venmo in terms of volume of transactions in July of 2018. Looking at the entire year, Zelle nearly doubled Venmo's total transaction volume.

Though one would be quick to say Zelle is winning the P2P payments battle, adoption remains lower than Venmo across every generation. Forbes notes that a key driver in the difference regarding transaction volume could be that Zelle is used by older generations as a more traditional bank transfer for items such as alimony payments.

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