Why we don’t expect negative rates in the US... yet

While President Trump likes the idea of negative interest rates, it's clear the bar is set relatively high for the Federal Reserve to adopt them. We are perhaps more likely to see sub-zero rates in Britain, but even here we think policymakers will be much more inclined to use quantitative easing for the time being

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The bar is set relatively high for negative rates in the US and UK

While US equity markets have surged back to within touching distance of their all-time highs, interest rate markets are pricing a far less rosy outlook. Even after May’s surprisingly strong jobs report, implied yields suggest little prospect of a US rate hike any time soon, with a slight bias towards the Fed cutting rates within the next 12 months.

It’s a similar story in the UK. The message from the Bank of England is that negative rates can’t be ruled out, and that’s helped push overnight index swaps (OIS) to price in negative rates.

But while we shouldn’t rule anything out, we still think that the bar is set relatively high for policymakers to take interest rates below zero – particularly in the US.

US President Trump clearly likes the idea – and the 'gift' of being paid to borrow may look attractive for a government expected to borrow more than USD 4 trillion this year – but Fed Chair Jerome Powell is clearly more cautious.

Powell is reluctant to head into negative territory

Powell recently noted that "for now it's not something we are considering" and "we think we have a good toolkit and that's the one we will be using". Here are some of the reasons why:

- **There's no pressing need.** After all, the combination of sharp interest rate cuts, "unlimited" QE and the re-ignition of various schemes from the financial crisis, has seen lending spreads narrow significantly and credit flow freely. Why would Jerome Powell and the Federal Reserve decide to cut rates into negative territory if they truly believe, as Powell stated on 10 May, that "when you have negative rates, you wind up creating downward pressure on bank profitability, which limits credit expansion"?
- **Experience in the eurozone and Japan shows the policy hasn't generated inflation.** Richmond Fed President Thomas Barkin stated that "I haven't seen anything personally that makes me think they're worth a try here"; a view widely shared within the FOMC. The criticisms you usually hear are that consumers don't always spend more, it hasn't generated inflation elsewhere, and central banks will have a hard time raising rates again, leaving less room for action if there is another downturn.
- **They could cause "significant complexity or distortions to the financial system"**, according to the October FOMC minutes. Policymakers also noted negative rates "could have more significant adverse effects on market functioning and financial stability here than abroad." It would certainly put pressure on the $4.8 trillion money market fund sector, with numerous funds already waiving management fees to ensure net asset values don't break below $1. The fear is that negative short-term rates result in an avalanche of redemptions that could lead to severe, but short-term, financial market strains.
- **Negative interest rates also create a disincentive for businesses to maintain cash buffers to deal with any financial stress** – such as, for example, the current pandemic, which is causing a massive blow to revenues and corporate profitability.

Negative rates could still come - but they're more likely in the UK than US

Given this backdrop and the fact recent US macro data has provided positive surprises, it is safe to say negative rates are not on the agenda, at least for now.

But the Fed has been very careful not to completely rule out negative interest rates and the Fed funds futures market thinks that the FOMC, like the Bank of England, could eventually soften its stance. The catalyst could be a second wave of Covid-19 and renewed lockdowns with associated economic and financial market distress.

One concern is that the hit to investment from Covid-19, and the resulting slowdown in productivity growth, could see the so-called neutral interest rate decline further. That means that 'in theory' an interest rate fixed at zero will become decreasingly stimulative as time goes on, which perhaps could see negative rates more heavily considered by policymakers in the future. It would also, theoretically, incentivise people to take more risk in their investments in the hunt for yield, take on more borrowing and spend more. All of which should boost economic activity.

But would this be any more effective than expanding the tools central banks are currently using? We don't think so.

While in the UK the potential for negative policy rates is perhaps greater because mortgage rates more closely follow Bank rate, it is working at the wrong end of the yield curve in the US. Longer-term Treasury yields are the benchmarks used to price mortgage borrowing and corporate credit meaning that formal yield curve targeting would likely be far more effective – discussed by our colleague Padhraic Garvey.

Moreover, Powell himself has eloquently made the point that "the Fed has lending powers, not spending powers". A renewed collapse in demand with a further rise in unemployment and state and local governments running out of cash requires the Federal government to step in. This means fiscal policy should carry the burden, supported by the Federal Reserve's QE strategy which should cap government borrowing costs as debt issuance surges.

It is doubtful a negative Fed funds rate would add meaningfully to this when considering the costs involved.

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