

Memo to: Oaktree Clients  
From: Howard Marks  
Re: Mysterious

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Most of the time, my memos have their origin in something interesting that's happening in the world or in a series of events I come across that I think can be interestingly juxtaposed. This one arises from a less usual source: a request.

The other day, my colleague Ian Schapiro, the leader of Oaktree's Power Opportunities and Infrastructure groups, suggested I write a memo about negative interest rates. My reaction was immediate and unequivocal: **"I can't. I don't know anything about them."** **And then I realized that's the point. No one does.** But Ian thinks I can make a contribution, so I'll try. I've been saving up clippings on this subject, as you'll see. Ian's urging set me to work.

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For a good while now, I've used the term "mysterious" in connection with inflation (and deflation). What causes rapid inflation? How can it be stopped? Economists offer explanations and prescriptions regarding each occurrence, but they rarely apply the next time.

And that brings us to the subject of negative interest rates. I find them no less mysterious. **The fact that we know what they are** – as we do with inflation and deflation – **doesn't alter the fact that we don't know for sure why negative rates are prevalent today, how long they'll continue in force, what might cause them to turn positive, what their consequences are, or whether they'll reach the U.S.**

### No, I'll Pay You!

Historically – until the European Central Bank took the rate on its credit facility to -0.10% in 2014 – borrowers paid interest to the people from whom they borrowed money. But in the recovery from the Global Financial Crisis, interest rates went negative for the first time in recent history, meaning some lenders paid borrowers for the privilege of lending them money.

I had my first direct brush with negative interest rates in 2014, when I was making an investment in Spain. The closing was due to take place on Monday, and I wired funds on the prior Wednesday so as to be in position to close. The following conversation ensued with my Spanish lawyer:

Carlos: The money has arrived. What should I do with it between now and Monday?

HM: Put it in the bank.

Carlos: You know that means you'll get less out on Monday than you put in today.

HM: Okay, then don't put it in the bank.

Carlos: You have to put it in the bank.

HM: So put it in the bank.

That's it in a nutshell. Money can't be free-floating in space. It has to be someplace. And you can't keep much of it in your wallet or under the mattress. Thus, in general, any substantial sum has to go into the bank. And in Europe – then and now – doing so means you'll get out less than you put in.

I have to admit that this didn't come as a shock to me. Oaktree and I had turned very cautious in 2005-06, and as a result, all of my money that wasn't in Oaktree funds was in a "laddered portfolio" of U.S. Treasuries. (In my case, equal amounts of 1, 2, 3, 4, 5 and 6-year maturities. When the closest-in note matures, you roll it to the end of the line. It's the most mindless form of investing known to man.)

At the time I put that portfolio together, I signed up for a yield in the range of 5-6%. And I was thrilled: the greatest safety, total liquidity and a meaningful yield. But then, in 2007, the Fed started cutting rates to rescue the economy from the sub-prime mortgage crisis. And one day in late 2008, my banker called to say, "The 6% note has matured. You can roll it over at five-eighths." I asked, "What-and-five-eighths?" "No, that's it," he said, "just five-eighths."

The world had changed. **Up until the Global Financial Crisis, we could store money with the government and be well paid to do so. But now my reaction was, "given the level of fear in the financial world, maybe one of these days people will end up paying to store their money safely."**

In the period 2008-14, Europe experienced the Global Financial Crisis, a European debt crisis (with concern over the solvency of "peripheral" nations on Europe's southern tier), and rapidly escalating prices for commodity raw materials. In response, the European Central Bank and some non-EU countries moved to adopt negative interest rates. Here's how it goes:

Commercial banks usually earn interest on the extra reserves they keep with central banks, like the Fed or the European Central Bank. Negative policy interest rates force them to pay to keep money in those accounts, a penalty aimed at pushing them to lend more and goose the economy. (*The New York Times*, September 9)

Central banks determine short-term base rates ("policy rates") as described above. That establishes the origin of the yield curve, and rates/yields on other types of short-term debt, as well as longer-term instruments, can be expected to respond by moving to a logical relationship with the base rate. Eventually, negative interest rates paid on bank deposits should be reflected in negative yields on bonds. (Note: for the most part, negative rates are applied today only to large deposits. Small depositors have thus far been spared.)

Today, large numbers of bonds – the vast majority being government bonds from Europe and Japan – carry negative yields to maturity. They constitute roughly two-thirds of the bonds in Europe and 25-30% of all the investment grade debt in the world. A few corporate bonds also offer negative yields, however, and there's even a handful of negative-rate high yield bonds (the ultimate oxymoron).

Further, on September 4 *Bloomberg* pointed out the prevalence of negative real rates:

While over \$17 trillion of the global stock of debt trades at nominal yields below zero, the figure jumps to \$35.7 trillion when inflation is taken into account. . . . In the U.S., more than \$9 trillion of the nation's government debt carries yields lower than the CPI rate.

With a negative-rate instrument, the price you pay for a bond today exceeds the sum of the face amount that will be repaid when it matures plus the interest you'll receive in the interim. That means if you buy a negative-yield bond and hold it to maturity, you're guaranteed to lose money. Why, then, would anyone want to buy a negative-yield bond? Here are some reasons that make sense:

- Fear regarding the future (relating to recession, market declines, credit crisis or further declines in interest rates, among other factors) that causes investors to engage in a **flight to safety**, in which they elect to lock in a sure but limited loss.
- A belief that interest rates will go even more negative, giving holders a profit, as it implies bonds will appreciate in price (as they would with any decline in rates).
- An expectation of deflation, causing the purchasing power of the repaid principal to rise.
- Speculation that the currency underlying the bond will appreciate by more than the negative interest rate.

The concept behind negative rates is simple. It's merely the reverse of the traditional norm, in which lenders receive interest from borrowers. Generally speaking, interest rates are a function of two variables: (a) the time value of money and (b) expected changes in the purchasing power of money (i.e., inflationary or deflationary expectations). (Of course, interest rates should also incorporate a risk premium to compensate for any credit risk entailed.) If, for example, lenders want a 2% annual real return to compensate for the time value of money and expect 2% inflation over the next five years, a five-year Treasury note should yield 4%. But if lenders expect deflation at 3% per year, that note should theoretically yield *negative* 1%.

**Are today's negative rates in Europe and Japan telling us deflation lies ahead? Or have lenders changed their views regarding the time value of money? Or are rates negative simply because governments and central banks want them to be?**

### Reasons for Negative Rates

Here are some of the reasons I've come up with for negative interest rates, some I've read about, and some my friends have suggested:

- The obvious one: **central banks in Europe and Japan want rates to be negative to stimulate their economies.** (They want to supply more stimulus than had been afforded by the reduction of rates to near-zero, since that level of stimulus didn't prove up to the task.)
- “. . . central banks around the world are racing to cut interest rates in an effort to stay ahead of the Fed and support their economies by weakening their currencies.” (*The Wall Street Journal*, August 12)
- Ongoing quantitative easing – central banks' bond purchases – is pushing up the price of longer-dated bonds, and thus pushing their yields down into negative territory.
- Quantitative easing means the central banks flood the financial system with money that needs investing. Since borrowers don't have much demand for long-term capital, they won't pay to use it. Thus holders have to pay a small fee to store that money.
- **Fearful investors have little interest in making investments that represent bets on their countries' economies and companies.** They certainly don't want to borrow for that purpose.
- Current economic weakness reinforces investors' pessimism. **Fear of increasing weakness in the future strengthens their desire for safe storage.**
- There's so much money in the system that the excess of supply over demand drives down the price of money – borrowing rates – into negative territory. “In today's global economy, private investment demand is manifestly unable to absorb private savings . . .” (Lawrence Summers, *Financial Times*, October 12)
- Unfavorable demographic trends mean central banks can't maintain positive rates without curbing growth.
- The lack of inflation means investors needn't demand protection against the loss of purchasing power over time. The wonders of technology may continue to make products available cheap or free, capping inflation.
- Fear of deflation adds further to the willingness to invest without such protection.
- “The rise of businesses dealing in intangible products has rendered the economy less capital-intensive . . .” said *Grant's Interest Rate Observer* on July 26. This reduces the demand for long-term borrowings.
- **Certain regulations require financial institutions to invest in home-country sovereign bonds regardless of the yield they offer (and whether it's positive).** This artificially lifts the demand for (and thus the prices of) those bonds.

Everyone has favorites from this list. But everyone differs, including the “experts.” Some people think we have negative rates because central bankers want them, some think it's because the market sets them, and some think it's some of each. “Did interest rates fall, or were they pushed?” asks *Grant's*. Given all the above, no one should feel the reasons for negative rates are fully understood.

### The Impact of Negative Rates

A quote attributed to Albert Einstein in various forms is relevant to this discussion.

Compound interest is the 8<sup>th</sup> wonder of the world. He who understands it, earns it; he who doesn't, pays it. (*RateCity*)

Under compound interest, by not withdrawing interest as it is earned, not only does an investor earn interest on his principal year after year (as with simple interest), but each year he also earns interest on the interest that was earned in the preceding years. Thus principal can grow powerfully if left invested for a long period. (At 10%, \$100 grows to \$300 in 20 years under simple interest, but to \$673 if allowed to compound.) What a wonder!

There's one problem, however. The miracle of compound interest works in reverse if the interest rate is negative, making Einstein wrong about its virtue. Who would want to reinvest income at negative rates? And where would income come from for that purpose?

**It's not just Einstein's observation that may be rendered invalid. Negative rates turn a lot of the usual processes upside down.** Here are several examples:

- Negative rates make life more difficult in a TINA ("there is no alternative") world. Many investors don't want to knowingly sign on for negative rates. **That makes risky investments preferable, even if they promise historically low prospective returns. In this way, risk aversion is discouraged. "I have no choice but to go into risky assets, because I can't accept a negative return on safe ones."**

There is clear evidence that this is happening among institutional investors. The flow of pension fund money into any asset that promises to beat zero-rate bonds has been so dramatic that equities, junk bonds, property, private equity and a host of other more abstruse areas of investment have spiraled in value – and to such an extent that they look highly vulnerable to any shock . . .”  
(*Financial Times*, August 5)

Proof? What about the fact that in early July, a €3 billion offering of Italian sovereign bonds maturing in 2067(!) was almost six times oversubscribed thanks to its lavish 2.877% yield? What a bonanza Italy was at the time, with a 10-year bond out-yielding Germany's 10-year by 215 basis points, 1.78% to -0.37%.

- There's no longer any reason to pay slowly in order to make money on "float."
  - In the old days, people paid their bills on the last possible day, preferring to keep the money in the bank and earn interest as long as possible. Under negative rates they may prefer to pay sooner.
  - Many insurers traditionally have made money primarily because they paid claims years after they collected the premiums on the policies they issued. What happens if it costs them money to hold float until claims are paid?
- Likewise, there's no impetus to collect receivables quickly. In the past, wholesale customers were offered discounts for paying bills early. Now the seller might say, "No, you keep it. I'd rather you paid me in six months."
- Negative rates put pressure on people, such as retirees, who live on the income from their investments.

- **Importantly, the pessimistic signals sent by negative rates may mean they have a contractionary rather than stimulative effect.**

Research has suggested that Japan's negative rate policies may have backfired, actually lowering inflation expectations instead of firming them, as hoped. (*The New York Times*, September 11)

Last week famously blunt ING boss Ralph Hamers excelled himself, all but calling the ECB idiotic for planning to shift rates further downwards. "The negative rate environment is making consumers so uncertain about their financial environment that they're starting to save more rather than less," he said.

Mr. Hamers has a point. Rather than encouraging people to borrow and spend, the data suggests nervous eurozone consumers are hoarding. Eurostat reports the eurozone household savings ratio is at a five-year high of nearly 13 per cent. (*Financial Times*, August 5)

- If interest rates for small savers ever were to go negative, it would give rise to the juxtaposition of income penalties for households with benefits for "the elites" through their ability to profit from rising equity prices. **Economic impact aside, the boost to populist politics would likely be dramatic.**
- Negative rates can distort the workings of floating-rate financial products. Lenders and depositors might have been happy in the past receiving interest rates at a spread over the base rate Euribor. With a negative base rate, however, loans and deposits might leave them with less money than they anticipated as time passes.
- Negative rates on U.S. Treasuries would, for example, harm the Social Security Fund (which can only invest in Treasuries), hastening the day when it runs out of money.
- **Negative rates can warp the calculation of discounted present values.** In particular, when the discount rate is negative, the present value of future pension obligations can exceed their future value. The combination of high discounted obligations and low yields on investments can be disastrous for the funded status of pension funds.
- **Ditto for the impact on bank profitability.** Negative rates charged to borrowers can sap the returns banks depend on, throwing countries' banking systems into reverse. Already, some banks have seen the need to issue mortgages with negative interest rates. "In a negative rate environment, the bank must pay to hold loans and securities. In other words, banks would be punished for providing credit . . ." (Jim Bianco on *Bloomberg*, September 3) "Certainly Europe's bankers are squealing, as they feel margins squeezed by low rates on lending and a reluctance to pass on negative rates to depositors." (*Financial Times*, August 5) Big banks can charge negative rates to corporate and HNW depositors, but as I mentioned earlier, thus far retail banks haven't passed them on to small savers. Doing so could cause those savers to leave the banking system, depriving it of a traditional source of deposits.
- What about the application of negative interest rates to corporate bonds? How will the markets value businesses that hold cash versus those that are deep in debt? Traditionally,

markets have penalized heavily levered companies and rewarded those that are cash-rich. But if having negative-yield debt outstanding becomes a source of income, will levered companies be considered more creditworthy? Conversely, how will the market value businesses that hold a lot of cash and thus have to pay banks to keep it on deposit?

- **Financial models and algorithms – which essentially are a matter of looking for and profiting from deviations from historic relationships – may not work as well as they did in the past**, since history (all of which has been based on positive interest rates) may be out the window.

Nobel prizes have been awarded to economists that developed concepts such as the efficient frontier, the Capital Asset Pricing Model and the Black-Scholes option pricing model. But when a negative value is assumed for the risk-free rate in these types of models, fair value results shoot off toward infinity. With trillions of securities and derivatives dependent on these models, valuation is critical. (Jim Bianco, *op. cit.*)

The one thing we can't be sure of is that negative rates increase economic growth (or produce more growth than is generated by low rates). First, this requires “what-if” analysis, which is one of the most difficult kinds: are Europe and Japan growing faster today than they would have if their rates weren't negative? And second, you surely can't look at their current growth and pronounce negative rates a huge success. Are negative rates stimulating demand, or are they a matter of “pushing on a string,” powerless to convince pessimistic consumers to spend?

**In the financial world, most of our actions are based on the assumption that the future will be a lot like the past. Positive interest rates and the desirability of compounding have been among the most fundamental historical building blocks.**

If negative rates become more widespread across the globe, then the financial system needs to be rebuilt on a new set of assumptions. The problem is that we do not yet know what those should be or how they would work. (Jim Bianco, *op. cit.*)

**At minimum, negative rates mean there's increased uncertainty, and thus we have to proceed with more trepidation. Whatever we knew in the past about how things worked, I think we know less when rates are negative.**

Will the U.S. See Negative Interest Rates?

As stated above, the vast majority of today's negative-yield bonds are in Europe and Japan. One of the biggest questions surrounds whether negative rates will reach the U.S.

This question takes me back to my immediate response to Ian's suggestion that I write this memo: **nobody knows, and certainly not me.** When something hasn't happened in the past, it's impossible to be sure you know how it'll end up. **Different people will express opinions on**

**this subject with differing degrees of confidence. Yet I remain certain that none of them “know.”**

If I had to take a guess – and that’s all it would be – I’d say interest rates won’t go negative in the U.S. in the current cycle. If we go back to the possible reasons for them listed on page four, I think we’ll conclude that the factors at play in the U.S. make negative rates less likely:

- Stronger current economic growth
- Better growth prospects
- Thus no need for emergency measures
- Higher inflation expectations (especially given the tightness of the labor supply)
- Less pessimism
- Better uses for long-term capital

**So I don’t think current conditions in the U.S. call for negative rates. But that doesn’t rule them out.** When you express an opinion, the real question is whether you’ll bet on it and whether you’ll give odds. I might put up \$60 to win \$50 from you if negative rates don’t materialize. But that’s not a sign of much confidence on my part.

**In particular, I wonder about monetary stimulus.** The U.S. fed funds rate is below 2% as I write, thanks to the two recent rate cuts (and there might be another cut on the way soon). Yet most stimulus programs have entailed rate cuts totaling several percent. So there’s every possibility that in the future, the Fed’s response to economic weakness could take rates into negative territory.

And the current slowdown in U.S. manufacturing – plus the uncertainty brought on by the on-again/off-again prospect of an escalating trade war with China – raises the possibility of a recession, and thus the need for stimulus through rate-cutting.

Some argue that strong demand for safe assets and negative demographic trends apply in the U.S. also, and thus U.S. bond yields can fall below zero.

Finally, negative rates abroad strengthen demand for dollars so foreigners can invest at the positive U.S. yields, causing the dollar to appreciate. Thus the Fed may have to lower rates to keep the foreign-currency cost of U.S. exports from rising too much, and thus their competitiveness from declining and our economy from weakening. **How long can the Fed maintain rates that are much higher than those in the rest of the world?**

Maybe I should reconsider my offer of 6-to-5 in favor of rates staying positive . . .

## What, Then, Is There to Do?

I'm convinced that no one should be categorical about how to deal with a mystery like this in such unprecedented and confusing circumstances. But the *Financial Times* of August 5 advanced one idea that seems perfectly logical:

For SFr1,000 a year, your typical Swiss private bank will give you a cubic metre of vault storage for your valuables. Thanks to Switzerland's high-value SFr1,000 notes, that should be enough space to salt away close to SFr1 billion in hard cash. The fee is a sight cheaper than the SFr7.5 million charge that a 0.75 per cent negative interest rate would imply.

If you don't like that idea, there is one more: **move out the risk curve to strive for returns above those offered by safe instruments in this low-return (or negative-return) world . . . but do so with caution.**

What does moving out the risk curve consist of? Essentially it means pursuing greater rewards while accepting the reduced certainty that by definition accompanies that pursuit. (If greater rewards could be obtained without a corresponding increase in uncertainty, that return increment would represent a free lunch, and most of the time they're not available.)

**In a world like the one described above, perhaps the most reliable solution lies in buying things with durable cash flows.** Bonds, loans, stocks, properties and companies with the likelihood of producing steady (or hopefully growing) earnings or distributions that reflect a substantial yield on cost all seem like reasonable responses in times of negative yields. **In my view, durability and dependability are highly desirable (rather than hail-Mary attempts at a moonshot). They are the Oaktree way.**

While all this might be self-evident, the challenge lies in accurately predicting the durability and growth of cash flows and making sure the price you pay allows for a good return. In today's market environment, assets with predictability are often priced extraordinarily rich, and investors are unusually willing to extrapolate growth far into the future. At the same time, with the economy and markets operating under rules that are different from those of the past in many ways – some of which are reflected above – accurate predictions are apt to prove harder to make than usual. **These are some of the reasons why, while simple in concept, investing is far from easy . . . especially today.**

October 17, 2019

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