In March of 2015 I authored an article for Government Treasurers’ Organization of Texas publication titled “Could Negative Rates Be On The Way To America?” (If you would like a copy of that article, just send me an e-mail at rpanzera@ffec.com). In it, I pointed to the striking similarities between the Depressions of 1921, The Great Depression starting in 1929 and the current ongoing global economic slowdown.

Very little has changed positively over the past 11 months. Commodity prices continue to tumble worldwide:

Source: https://research.stlouisfed.org/fred2/series/PALLFNINDEXQ
Economic activity in the US seems to be stuck at “stall speed”:

Source: [https://research.stlouisfed.org/fred2/series/NEWORDER](https://research.stlouisfed.org/fred2/series/NEWORDER)

While the US Gross Domestic Product (“GDP”) growth is sickly, the European Economic Community and Japan (the third largest economy) are worse:
Real GDP
Percentage Change from 2008 Q1, Seasonally Adjusted

United States
Euro Area (17 Countries)
Japan
UK

Source: OECD Main Economic Indicators, GDP Constant Prices

Source: https://econsnapshot.files.wordpress.com/2016/01/gdp-us-eu17-japan-uk2016-01-291.png
China claims that in the fourth quarter of 2015, GDP grew by only 6.8%. That is the slowest rate of growth since the global financial crisis in 2009. 

Perhaps a better way of looking at economic activity in China is the Baltic Dry Index. China is the largest importer of bulk materials and one of the largest exporters of finished goods using marine shipping. “The Baltic Dry Index (BDI) is a measure of what it costs to ship raw materials—like iron ore, steel, cement, coal and so on—around the world. The Baltic Dry Index is compiled daily by The Baltic Exchange. To compile the index, members of the Baltic Exchange call dry bulk shippers around the world to see what their prices are for 22 different shipping routes around the globe. Once they have obtained these numbers, they compile them and find an average.”

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On February 10, 2016, the Baltic Dry Index, which has been around for 30 years, hit an all-time low of 290. ³

Like during the Depression-Era 1920’s-1930’s, currency wars have broken out where one country tries to weaken their currency at the expense of other countries’ trade balances.

The Chinese currency has been devalued against the US dollar and the Euro since last summer.

Source: http://www.exchangerates.org.uk/USD-CNY-exchange-rate-history.html
While the Euro has been pushed down relative to the US Dollar.
Australia and Canada currently have portions of their yield curve inverted. That could be an important indicator of an economic slowdown. 4Seven out of the last seven recessions in the US have been preceded by an inverted yield curve over the past 50 years. That’s a pretty good prediction record. 5

A healthy percentage of the world’s central banks have embraced negative interest rates as a methodology to spark economic activity, most recently Japan in late January 2016.

4 Shedlock, Mish (2016, February 12) http://www.fxstreet.com/analysis/mishs-trend-analysis/2016/02/12/
The central banks’ theory seems to be that if consumers/companies are forced to pay the government to hold cash, then the consumers and companies will spend that money on goods and services. How’s that working out for them? Perhaps not as well as intended, as shown in the charts below:
As interest rates approach zero, gross savings increase. Perhaps people are nervous about the economies of the world and are hoarding cash. Since Japan dropped rates negative in late January 2016, there has been a run on safes as the ever-thrifty Japanese populace tries to avoid the “tax” by hoarding cash.  

In Europe, European Central Bank’s Governing Council voted to withdraw the 500-euro note this month to discourage hording and force people to use the banking system.

If some of these ideas seem far-fetched, consider this:

“Ray Dalio, founder of the world’s largest hedge fund Bridgewater Associates, says the next big monetary and fiscal move should include an airdrop of money from helicopters to stimulate the U.S. economy.

He may not be entirely serious about "helicopter money." But in a client note sent out this week, Dalio said the U.S. Federal Reserve’s ability to boost growth through lowering interest rates and quantitative easing is "weaker than it has ever been."

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"Monetary Policy 3" or MP3 will have to be directed at spenders more than at investors and savers, he said.

Dalio, who characterized lower interest rates as MP1 and quantitative easing as MP2, proposed some scenarios in which MP3 could be implemented.

"We can say that the range will extend from classic fiscal/monetary policy coordination - in which debt to finance government spending will be monetized - to sending people cash directly - i.e., helicopter money - and will likely fall somewhere between these two -i.e., sending people money tied to spending incentives," Dalio wrote.

Helicopter money is a reference to an idea made popular by the American economist Milton Friedman in 1969 that dropping money out of helicopters for citizens to pick up was a sure way to restart the economy and effectively fight deflation.

Dalio, who helps manage $155 billion at Bridgewater, said investors should expect currency volatility to be greater than normal when countries are fighting for growth.

When interest rates cannot be lowered and relative interest rates cannot be changed, currency movements must be larger, Dalio said. Indeed, the Bank of Japan's shocking move to take one of its main interest rates into negative territory last month led to weakness in the yen.

"To avoid economic volatility, currency movements must be larger," Dalio wrote. "That reality creates 'currency wars,' pegged exchange rate break-ups, and increased currency risk for investors."

Since currency movements benefit one country at the expense of another, he added that exchange rate shifts will not create a needed global easing. "That's just how the economic machine works."

For these reasons, investors should expect to experience lower than normal returns with greater than normal risk, Dalio said. Asset prices have fallen largely as a result of this, together with deflationary pressures brought about by most economies being in the later stages of their long-term debt cycles, Dalio said."

As I suggested in that article last year, negative interest rates could possibly be coming to America.

“As interest rates turn negative around the world, the Federal Reserve is asking banks to consider the possibility of the same happening in the U.S.

In its annual stress test for 2016, the Fed said it will assess the resilience of big banks to a number of possible situations, including one where the rate on the three-month U.S. Treasury bill stays below zero for a prolonged period.

Three-month bill rates have slipped slightly below zero several times in recent years, including in September after the Fed delayed rate liftoff amid global financial market turmoil, touching a low of minus 0.05 percent on Oct. 2.

But in the stress test, banks would have to handle three-month bill rates entering negative territory in the second quarter of 2016, and then falling to negative 0.5 percent and holding there through the first quarter of 2019.”

It’s important to note that negative interest rates never occur naturally in the market. After all, who would pay a borrower interest to lend him money? Negative interest rates mean the lender pays the borrower for the privilege of lending him money. It’s a bizarre, upside-down concept. Negative rates can only occur because the central bank forces them lower. If the Fed is stress testing negative rates, you could assume they may be considering them.

One of my favorite financial bloggers, Mish Shedlock, probably summed it up the best:

“Low and negative rates have not done a damn thing for the Eurozone, Switzerland, Japan, or any other country that’s implemented them. Nonetheless, Fed lemmings want to test how banks would handle negative rates.

In the inane attempt to get consumers to spend more money and to stave off threats of consumer price deflation, central banks keep punishing the prudent as well as those on fixed incomes.

Low interest rates foster economic bubbles. And it’s asset deflation not CPI deflation that central banks ought to fear.”\(^{10}\)

Other market participants see similar problems ahead:

“A year ago, with U.S. equities approaching record highs and the Federal Reserve moving toward raising interest rates, Gary Shilling was a lonely voice on Wall Street predicting financial-market gloom in the 12 months ahead.

Today, the 78-year-old analyst’s calls for $20 oil and a 1 percent yield on 10-year Treasuries look increasingly likely, and he’s sticking with them. The price of West Texas crude has fallen by half to $27.62 since Shilling made his $20 prediction last February, while benchmark Treasury yields have tumbled to 1.68 percent after rising to as high as 2.5 percent in June.

The man who five decades ago became the first chief economist at Merrill Lynch Pierce Fenner & Smith has witnessed numerous boom-and-bust cycles. Yet following history’s playbook won’t help this time around, he says. The world’s biggest economies are faltering with inflation stuck near zero even amid unprecedented central-bank stimulus, while the Federal Reserve has amassed trillions of dollars in Treasuries.

“The majority of people somehow are looking for steady patterns and simplistic answers,” Shilling, president and founder of Springfield, New Jersey-based research firm A. Gary Shilling & Co., said in an interview. “They’re looking for something that fits into what used to be the regular cycles, but this is just not anything like that.”\(^{11}\)

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\(^{10}\) Shedlock, Mish, Mishtalk Blog, 2016, February 03), http://mishtalk.com/2016/02/03/like-lemmings-over-a-cliff-fed-to-test-negative-interest-rates/

Jeffrey Gundlach is the founder of Doubleline Capital, an investment firm. He was formerly the head of the $9.3 billion TCW Total Return Bond Fund, where he finished in the top 2% of all funds invested in intermediate-term bonds for the 10 years that ended prior to his departure. Barron's in a February 2011 cover story called him the "King of Bonds." Gundlach remains highly skeptical about future rate hikes. "The market is going to humiliate the Fed," he said.\(^\text{12}\)

“Don’t count the U.S. out just yet when it comes to negative interest rates. Market bets that the U.S. Federal Reserve will go negative are higher in 2017, compared with this year, based on options pricing of the world’s most actively traded short-term interest rate contracts. A strike of 100 in the contracts, priced in three-month Libor, or the London interbank offered rate, implies

\(^{12}\) *ThinkAdvisor*, (2016, January 21), [http://www.thinkadvisor.com/2016/01/21/gundlach-on-economy-the-primary-trend-is-down](http://www.thinkadvisor.com/2016/01/21/gundlach-on-economy-the-primary-trend-is-down)
negative U.S. policy rates. Open interest on call options for euro-dollar futures with strike at 100 for next year has surged as concerns surrounding a slowdown in China and falling oil prices stall a recovery in U.S. inflation and growth.”

If you have not given much thought to what negative rates may do to your city, county, school district or hospital investment returns (or your principal, for that matter), may I respectfully suggest you investigate your opportunities while there is still time to do something?

I would be happy to have a discussion with you about some strategies and possible alternatives that are legal investments for public entities in Texas.

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Best Regards,

Ric

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P.S. The finest compliment we can ever receive is a referral from our clients and friends. Thank you.