Hello Everyone,

It just gets weirder and weirder. Late last week, Greek interest rates went negative. Yes, Greece. If you loan money to an insolvent (or at a least close to insolvent) Greek government, you pay them interest.

What makes this even stranger is, the "market" is telling you Greek debt is safer than US debt. Uhhhh, OK.

Future historians will shake their heads in amazement.

So, if you haven't guessed by now, the subject of today's missive is once again negative interest rates. Or better said, how negative rates are affecting the banks. Exciting. I know.

Still, if you grasp how destructive these policies are, you will become a better investor.

Signed Your Now-Frequently-Says-"I've-Never-Seen-This-Before"-Financial Advisor,

Greg

KKOB 10.15.2019 The Problem with Negative Rates

Bob: So, Greg, one of the things people can't seem to wrap their minds around is negative interest rates. For example, with negative rates, if you loan the Japanese Government money for 5 years, you pay the government 2% per year.

Or, if you get a mortgage in Denmark, the bank pays you the mortgage interest each month. It all seems so unnatural.

Greg: It is unnatural. But, Bob, it's reality for $17 trillion of global debt. Rates are negative in countries like Germany, Japan, & Switzerland. Bob, these aren't third world nations.

So, let's connect some dots and examine how destructive negative rates can be to the markets. And, let's start with banks.

Bob let's pretend you are the president of a bank in Germany. Obviously, your depositors expect you to pay them some interest on their savings. But what most people don't know is you also have money/reserves at the European Central Bank. And, since rates are negative, you pay them interest, too. So, you are paying interest up to Central Bank---as well as out to your depositors.

Bob: Wait. So, as bank president, no one is paying me interest? That seems bad for me. That means my profits fall, right?

Greg: Right. And that is what we are seeing across the globe---and partially why stocks like Deutsche Bank are down over 90%.

So, let's bring the example back to the US. Let's pretend you are the president of a local bank. In the olden days, one easy way to make money was this. You would ***pay*** grandma 2% on a 2-year CD and then ***issue*** a 30-year home mortgage to her 24-year old grandson at 7%.

So, you're paying grandma 2%, but making 7% on junior. 5% spread. Nice business.

But, that's now yesteryear stuff. Today, rates are so low, grandma gets 1.5% for her CD, but junior's 30-year mortgage only pays you 3.5%. Now instead of making 5%, you're making 2%. And, if rates go lower, as lots of people are predicting, that difference gets even smaller.

Bob: So, this is why my credit card interest rate stays so high. It's one of the places the bank can compensate.

Greg: Exactly. And, it might also be the reason why we are seeing distrust among the banks themselves. For the last month, they have been reluctant to loan to each other.

I think this is telling us something. The market wants to push interest rates up based on the risks in the banking sector. Meanwhile, the Federal Reserve is rushing in and printing money to keep rates low.

Anyway, last point. One more area where negative rates adversely affect the banks is banks become reluctant to foreclose on bad loans.

Here's why.

If banks foreclose, they post a loss…sometimes a big loss. So, rather than admit it, banks continue to float insolvent borrowers.

Eventually that behavior trickles into an economy where poorly run companies live on----based on borrowed money. We call them Zombie companies.

Bob: It sounds like ***Weekend at Bernie's*** where they prop the dead guy up to keep the party going.

Greg: You are not the first one to make that analogy…because it's spot on.

Bob: OK. So, let me sum up. Not only are negative rates unnatural… they are also destructive. Where we are seeing this first is in banking--- because they are closest to the negative rate machine.

So, my questions are these. Central Banks must know this. Why did they go negative in the first place? And, if it's not working, why keep it up?

Greg: Thank you! Exactly. Their answer would be, *"Hey, we want people to spend not save. And negative rates punish savers. Oh, and rising rates are kryptonite to stocks and bonds. Got to keep those rates low."*

Bob: But you have said this before, you can't spend your way to prosperity. It sounds like they have things backwards.

Greg: Which is exactly my point ---and thousands of others who are watching this financial experiment with horror. And with that, I am out of time.

Bob: Interesting as always. How do people reach you?

Greg: My number is 508-5550. Or, go to zanettifinancial.com.