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## Should we be afraid of negative interest rates?

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If you are wondering whether a “negative interest rate” means that a lender must pay interest to a borrower – it really does. Negative interest rates were created by central banks to discourage saving and encourage borrowing to stimulate the economy. Thus far, lenders such as bond investors appear to be just fine with this arrangement, judging from the growing list of bonds trading at negative yields. In late January, the Bank of Japan announced that it would charge interest to commercial banks for parking excess reserves at the central bank. Japanese government bond yields promptly turned negative for maturities of up to nine years, joining the numerous sovereign bonds in Europe that have had negative yields for over a year.

To make sense of this oddity, it helps to examine the motives of today’s lenders. Individuals enjoy the convenience of having a reputable bank keep their money safe and offer the ability to conduct a variety of banking activities. It would be risky and highly inconvenient for individuals to keep their banknotes under the mattress, carry them around when travelling and send physical cash by mail to businesses to settle recurring bills. To avoid these headaches, most individuals are likely willing to pay a premium above their existing banking fees; in other words, they are willing to accept negative interest rates. Institutional bond portfolio managers are often evaluated based on their performance relative to an index. To avoid the risk of large relative underperformance, some managers (not us) are willing to accept losses in absolute terms in favour of preserving relative performance. At a certain point, however, the cost of a negative interest rate outweighs the benefits and lenders, whether they are individuals or institutions, will ask for their money back. Thus, there is a limit to how low negative interest rates can go.

Though the Bank of Canada has stated that it is open to using negative interest rates, we likely will not see them in Canada in the near future. Canadian savers already have to contend with negative real interest rates since most short-term instruments offer yields that are lower than the rate of inflation. Reducing interest rates below zero would further weaken the Canadian dollar and stoke even more inflation due in part to the rising prices on imported goods. Additionally, commercial banks could face additional pressure on their net interest margins, a measure of profitability, as lending rates could decline faster than deposit rates, which need to be sufficiently attractive (even if negative) to maintain their client bases. Finally, the federal government appears committed to increasing fiscal spending to stimulate growth, thereby reducing pressure on the Bank of Canada to act too aggressively. As a caveat, if oil prices decline much further, the Bank may have no choice but to join the sub-zero club.

The fact that central banks are becoming increasingly comfortable with lowering interest rates below zero highlights the considerable upside potential in bond markets, especially where yields are still positive. Combining the expanded upside potential of bonds with the well-known potential of a loss if interest rates

rise, we are operating in an environment with an unusually wide range of potential returns. Negative interest rates are unquestionably a serious problem for the traditional saver who relies on a static, single-asset strategy such as owning GICs. Today's dynamic environment presents more opportunities for flexible income strategies that buy low, sell high and earn additional alpha from actively adjusting allocations to different asset classes.

*Combined top 15 equity holdings as of January 31, 2016 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:*

1. Alphabet	6. Tourmaline Oil	11. Chubb Limited
2. Microsoft	7. Apple	12. Synchrony Financial
3. Altagas	8. Atco	13. Simon Property Group
4. CGI Group	9. Toronto-Dominion Bank	14. Medtronic
5. Manitoba Telecom Services	10. Thermo Fisher Scientific	15. CIBC

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