Key Questions

Will US Interest Rates Fall Below Zero?

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We are monitoring the situation closely and exploring alternatives.

In the past two months, the US Federal Reserve (Fed) has unveiled a veritable alphabet soup of programs designed to support the economy. These measures include outright bond purchases as well as credit facilities to support both the municipal and corporate credit markets. The Fed has also slashed its primary interest rate, the federal funds rate, to 0%.

Low interest rates are thought to stimulate lending by making borrowing more attractive, resulting in higher levels of investment and economic growth. Recent Federal Reserve commentary indicates that very low rates will likely remain in place for quite some time. The Treasury market agrees, with 2-year Treasury notes yielding a mere 0.17% at the time of this writing.

Recently, futures markets were pricing in a negative fed funds rate by the end of 2020. Many commentators are now asking a previously unthinkable question: Will interest rates fall below zero in the United States?

Recall that several other central banks, including the European Central Bank as well as the Bank of Japan, are currently experimenting with negative interest rates. As we discussed last summer:

"Commercial banks and other lending institutions store a portion of their deposits at the central bank. The central bank pays interest on these deposits at a rate that is based on its policy rate. Once a central bank cuts this policy rate to below zero, instead of paying these depositors interest, the central banks start charging them to park money there. The hope is that this "fee" will encourage lending and investing, thereby stimulating the economy and lifting inflation. Some inflation, after all, is good for an economy." -- Key Questions, July 15, 2019

Recently, Fed Chairman Jerome Powell has remarked that negative interest rates are not under consideration "for now." Negative rates are essentially a tax on banks, and empirical evidence regarding the impact of negative rates on economic growth is mixed at best. Negative interest rates would also pose a logistical problem for money market funds, of which the Fed is undoubtedly aware.

Instead, the Federal Reserve is hoping that its various credit/bond purchase programs and its extended 0% interest rate policy, will help lift the economy out of its current doldrums while moving inflation back up. In a recent 60 Minutes interview, Powell stated that there is "no limit" to the Fed's ability to support the economy. In the same interview, Powell once again expressed his disdain for negative rates.

It is fair to wonder what might cause the Fed to change course and cut rates below zero. The global economy is interconnected, and no policy decision is made in a vacuum. If competing central banks such as the Bank of Japan or the European Central Bank were to reduce rates further into negative territory, the Fed might be forced to respond to maintain currency exchange rate stability. Another severe disinflationary shock (such as a second wave of COVID-19) could also force the Fed's hand.

In summation, we don't believe the Federal Reserve will cut rates below zero unless its current extraordinary measures prove ineffective, and growth/inflation expectations drop even further.

At Key Private Bank, we are closely monitoring this situation and exploring alternative short-term cash strategies should interest rates continue to fall. We are also carefully considering other tools to provide diversification and some level of income and stability of principal.

We will communicate more details as they become available. In the meantime, stay safe and (like US rates) try to avoid negativity.

For more information, please contact your Key Private Bank Advisor.

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