Weekly Commentary

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Fed negative about negative rates

Investing is driven by expectations. Stock market prices reflect investor outlook on the health of companies, the state of the economy, the uncertainties of politics and other factors. Interest rates follow a similar course, but it is expressed through the federal funds futures market. The big difference is that investors must also try to read the minds of Federal Reserve policymakers. Recently, the futures market has been predicting they will adopt a negative interest rate policy in 2021. We aren't buying it. Fed officials have spoken in concert to dispel this notion, including a webcast appearance by Chair Powell this week. They think the tools they are using—forward guidance, quantitative easing and special lending facilities—are working well to support market functioning and provide ample liquidity. If anything, they might need to increase the magnitude of each. Powell cautioned that the recovery may not happen as quickly as many have anticipated, and that the Fed will have to be on guard.

Just to be clear, negative rates are not the same as negative yields. The latter change as a function of supply and demand, not official policy. In fact, negative yields can happen only in the secondary market for Treasuries, as the government is not permitted to auction securities with yields below zero. During the time of deepest turmoil in March, Treasury yields on the short end did trade with negative yields, but it was short lived. We don't expect that to happen again anytime soon. But if it did, we have confidence these episodes we would have other investment options that offer positive yield to offset that.

The London interbank offered rate (LIBOR) curve continued to fall this week as it adjusts to the lowered federal funds rate range. One-month LIBOR declined to 0.17%, 3-month to 0.38% and 6-month to 0.66%.

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