Negative interest rates in Canada?

There is a quick rule for calculating roughly how long it takes to double money, called the "Rule of 72". Dividing that number by your expected rate of return will give you a rough idea of how long it will take for your money to double. If the equity market is expected to provide 8%, its historical average, then every nine years your money should double – if you earn the average every year. As the rate of expected return is tied to risk, investment counsellors may find this Rule instructive when constructing the asset mix for clients. The Rule even works for a zero return as money invested without a return will obviously never double. But who would invest for zero return?

"The Bank is now confident that Canadian financial markets could also function in a negative interest rate environment," said Bank of Canada Governor Stephen Poloz in December of 2015. How many years would it take to double an investment at negative rates? What is the case for investing in bonds if rates go negative? Who would buy a bond with a negative return?

First, we should clarify the position. Bonds could trade to negative yields in Canada, but there are no guarantees of this drastic policy action coming from the Bank of Canada. The current overnight rate is 50 basis points, which is historically quite low, but the Central Bank still has room to move before rates go negative – and to be sure other, less blunt implements are likely to come into play before rates move below zero. The Bank, as evidenced by Mr. Poloz's comments above, is likely to do a great deal of talking about negative rates before imposing them as "going negative" has some pretty extreme attachments to it.

Canadians are used to being charged a fee for their banking, but a negative rate environment could mean that a deposit of $10,000 falls to $9,950 in a year. Over and above a fee for maintaining a bank account, money will effectively disappear from the account each month. The intent of negative rates is to push deposits into the system, either through consumer spending or through investment. This experiment has been run in Europe, and the answer is that it works – sort of. Savers are prepared to accept some level of negative yields to maintain liquidity, which on its face seems odd, but it can also be understandable behaviour.

Which brings us to buying bonds with negative yields, and who would do that? Lots of people. Insurers looking to match liabilities, funds who have to own Government debt, those who believe that a small negative yield is worth the guarantee for repayment of principal, and those who are avoiding all risks other than trivial losses. Negative yield bonds are unlikely to be seen in Canada, and corporate bonds will continue to offer spreads which will create positive returns. The trend for real returns on fixed income has been around 2% in the past, this trend may be tested by negative rates – if we see them in the future. Negative rates could feel deflationary, they would test both conventional math and patience. We have seen negative rates in Europe, and European investment continues. The markets, and banks, remain open. The great continental experiment with negative rates should give everyone a sense of relief, the markets continue on.

Fixed income has always involved being patient, prudent investment involves thinking the long game. No matter where rates go tomorrow, there is no need to fear them.