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Investment Insights: Whatever It Takes

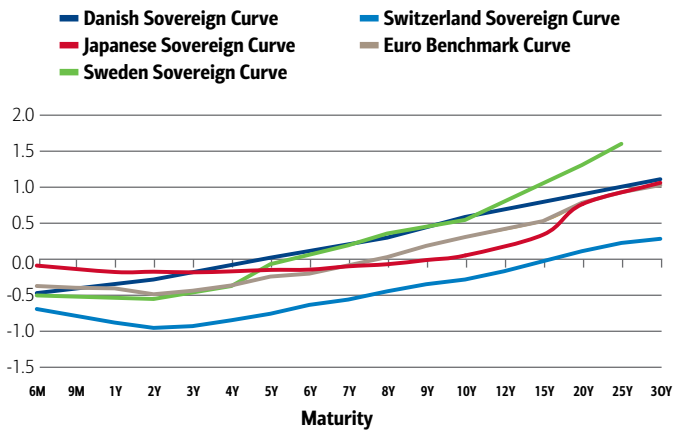
Recent commentary and reaction by central banks have helped to slow the market correction, which has now pushed U.S. equities (as measured by the S&P 500 Index) down 5.8% since the start of the year (through February 4). But possibly more alarming to the central banks than the fall in equities has been the strengthening of the yen and euro, both of which appreciated around 2% on a trade-weighted basis in the first three weeks of January and undermined the easing the central banks were aiming for.

Comments by European Central Bank (ECB) President Mario Draghi and actions by Bank of Japan (BoJ) Governor Haruhiko Kuroda have reminded markets that they are committed to doing whatever it takes to promote growth and arrest deflationary trends. Draghi continues to repeat his "do whatever it takes" line, which markets interpret as a promise to expand quantitative easing and lower interest rates (already in negative territory) further at the ECB's next policy meeting, in March.

Last week, the BoJ surprised markets by adopting negative rates for the first time, joining the central banks of the eurozone, Switzerland, Denmark and Sweden, all of which already have negative interest rates (see Exhibit 1). **A large swath of the developed world is now living with negative interest rates.** The Japanese authorities present negative rates as a new and, as there is no limit to how low rates can go, potentially unlimited monetary policy tool. By contrast, central banks recognize the limits of their asset purchase tool, where they commit to monthly purchases of sovereign debt over a longer period of time. In the eurozone, there has been palpable resistance to expanding the asset purchase scheme by certain member states. The BoJ already purchases 100% of net new issuance in the secondary market, and analysts question how much more debt the central bank can consume without entirely crowding out the private sector.

Negative rates are now the BoJ's unlimited tool, allowing the central bank to make a credible show of force in its commitment to meet its 2% inflation target.

Exhibit 1: Sovereign rates turning negative



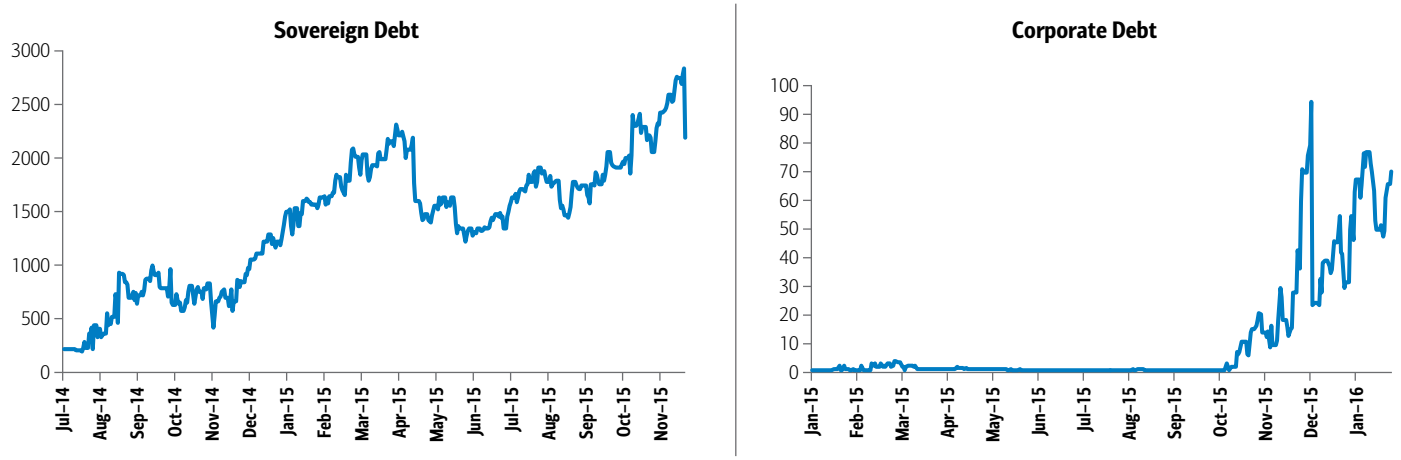
Source: Bloomberg and Chief Investment Office. Data as of February 4.

How low can they go?

Although in theory negative rates have no lower limit, in practice the BoJ will apply them only to a small, 10 trillion yen, subset of the total 250 trillion yen in excess reserves. Starting on February 16, the BoJ will introduce a multiple-tier interest rate structure similar to those of central banks in Europe (e.g., the Swiss National Bank)[1]. The BoJ will charge financial institutions negative 0.10% (10 basis points) to park reserves in excess of the average amount of reserves that were already stashed there in the past year. Financial institutions will continue to earn a small positive rate of interest on the remaining excess reserves that they had already put at the BoJ. The BoJ is also not applying negative rates to required reserves, and does not expect banks to pass on the negative rates to consumers and firms. It does hope

[1] Bank of Japan. "Introduction of Quantitative and Qualitative Monetary Easing with a Negative Interest Rate," speech by Governor Haruhiko Kuroda, February 3.

Exhibit 2: Negative-yielding sovereign (in $ bn) and corporate debt (in $ bn)



Source: Bloomberg, Bank of America Merrill Lynch Global Research and Chief Investment Office. Data as of February 2.

that it will stimulate banks to lend and lower the cost of capital for companies, so they can raise wages in the upcoming negotiations and increase their capital expenditures.

In the eurozone, the negative rate experiment is already more than a year old. Roughly 2.5 trillion euros of sovereign debt and 60 billion euros of corporate debt carry negative rates (see Exhibit 2). Switzerland, Denmark and Sweden followed in introducing negative rates. Switzerland and Denmark implemented negative rates to fight currency appreciation that had been driven by rising and disruptive capital inflows. The ECB and the Swedish central bank implemented negative rates to fight deflationary pressures and maintain accommodative financial conditions by stimulating consumption and investment over saving. Accounting for inflation, real rates were too high as inflation fell, so central banks lowered nominal rates to push real rates lower.

Unintended consequences

Negative rates are intended to encourage banks to lend, corporations to borrow and invest in plant and equipment, and households to purchase houses and durable goods on loan. However, they can have adverse side effects. For example, banks may not increase lending, but instead may leave the liquidity in their accounts at central banks. Banks' profitability and net interest margins can compress and their profitability can fall. In addition, corporate debt yields can dip into negative territory as well, as seen in the eurozone.

Banks can also pass negative rates on to consumer and corporate clients, with perverse consequences. In Denmark, certain mortgages now bear negative interest rates, whereby the borrower *receives* interest payments from the bank. For consumers, negative rates reduce the return to savers, increase the incentive to borrow, and make holding physical cash an increasingly attractive alternative to keeping money on deposit in a bank account.

Negative rates could make the market more prone to poor capital allocation and credit decisions. Pension funds and insurers with statutory obligations to invest in sovereign debt are more likely to undershoot their return targets in a low long-run rate environment and face asset liability mismatches as sovereign debt yields move below zero. Insurers offering guaranteed annuities may find it more difficult to meet these guarantees. Negative rates also increase the reach for yield, as yield-seeking investors take more duration risk by moving further out on the maturity curve, or more credit risk by switching from ultra-low or negative-yielding sovereign debt to higher-yielding but lower-quality corporate debt. It is equally likely that falling yields in Europe and Japan will keep U.S. Treasuries and corporate debt very attractive to foreign investors on a relative basis. Equities may also be distorted. Investors will seek the greater potential return and, in particular, as the risk-free rate falls to or below zero, equity valuations will be pushed up as the cost of capital falls. In this climate, the search for yield pushes investors further out the risk curve, a potentially destabilizing undertaking over the medium and long term.

Negative U.S. rates unlikely

During the crisis, the Federal Reserve (Fed) likely opted NOT to use negative rates because of the harm to money markets and mutual fund complexes. U.S. money fund complexes are statutorily obliged to return a positive net asset value and play a proportionately larger role in the U.S. financial markets than do European or Japanese money funds. However, in recent commentary, Fed officials expressed a willingness to consider negative rates in the event that the outlook drastically worsens. So far, they view the economy as still on a solid, though slow, growth path. In our view, growth will remain low and slow for another few years, but the U.S. will not be taken down by the manufacturing recession or the turmoil in China. One by-product of negative rates is that, over time, they will diminish the attractiveness of certain currencies as global reserve currencies. This could prolong the position of the U.S. dollar as a dominant global currency.

What this means for markets

In equities, high-dividend stocks will remain relatively more attractive as bonds look increasingly expensive. We continue to see high-quality and large-cap stocks as the best option in a market beaten down by the correction. We also continue to view fixed income as an essential part of a diversified portfolio, and to like high-quality municipals and some parts of the investment grade corporate bond market. Nonetheless, the tumultuous start to 2016 underscores our view that volatility is here to stay. Investors with essential liquidity needs should maintain cash-like investments to meet those needs and tolerate the volatility on other parts of their portfolio devoted to meeting longer-term goals.

CHIEF INVESTMENT OFFICE

Christopher Hyzy
Chief Investment Officer
Bank of America Global Wealth & Investment Management

Christopher J. Wolfe
Head of the Merrill Lynch Chief Investment Office

Mary Ann Bartels
Head of Merrill Lynch Wealth Management Portfolio Strategy

Karin Kimbrough
Head of Macro and Economic Policy

Maxwell Gold
Vice President

Emmanuel D. "Manos" Hatzakis
Director

Jon Lieberkind
Vice President

Niladri "Neel" Mukherjee
Managing Director

John Veit
Vice President

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