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Negative Rates Pose Grave Risks to Banks

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Unless the Negative Interest Rate Policies (NIRPs) that were brought upon the world by central banks are eliminated, a meltdown of the world's banking system is unavoidable. Japan's central bank instituting a negative interest rate policy (NIRP) earlier this year has resulted in all of the country's money market funds closing and the spreading of negative interest rates globally. The NIRP that was instituted by the European Central Bank (ECB) in 2014 has put Europe's banking system on the verge of a crisis.

During the first two months of 2016, I observed a degree of volatility that I had only seen once throughout my 40-year career in the markets, and that was in 2008. Given my experience and track record for developing algorithms that successfully warn investors about potential catastrophes — including Lehman, Bear Stearns and Merrill Lynch documented in my 2007 *Equities Magazine* column — I conducted extensive research on the crash of 2008. Through this research I discovered metrics that could have been used to predict the 2008 crash, and the V-shaped reversal. These metrics are now powering an indicator or warning system that I developed and named the "NIRP Crash Indicator" which I am utilizing to monitor the markets for indications of any impending crash. The NIRP Crash Indicator is freely available at www.dynastywealth.com.

The terms "NIRP" and "negative interest rate" should not be confused or intertwined. A NIRP is the inside rate, formerly known as the "discount rate", that a central bank charges on the reserves that are held in its member banks. A negative interest rate is not established or set by a central bank. The market instead sets it. It is entirely possible that the sovereign debt securities of a country could have a negative yield even though its central bank has not instituted a NIRP.

Negative Rates Pose Risks to Banks

NIRPs and negative interest rates are much more lethal to the world's banks than the subprime loans, subprime mortgages, and credit default swaps — the causes of the crash of 2008. Based on my exhaustive research, my conclusion is that it is impossible for a bank in the U.S., or any country, to remain a bank under a scenario where interest rates on treasuries or sovereign debt securities are negative. The comparative tables below for my Savings & Loan (S&L) example illustrate the marked difference that a negative interest rate has on the profits and losses of a banking institution. Please note that my interest rates and 50% loan-to-deposit ratio are hypothetical.

Savings and Loan's Profits/Losses with U.S. Treasury Notes @ Yield +1.0%	
S&L Transactions:	**S&L Expenses/Income**
Savers deposit $1 million into 2% interest savings accounts at S&L	-$20,000
S&L provides $500,000 of mortgage loans @ 4%	+$20,000
S&L invests remaining $500,000 of deposits into U.S. Treasuries paying 1%	+$5,000
S&L profit	**$5,000**

Savings and Loan's Profits/Losses with U.S. Treasury Notes @ Yield (-1.0%)	
S&L Transactions:	**S&L Expenses/Income**
Savers deposit $1 million into 2% interest savings accounts at S&L	-$20,000
S&L provides $500,000 of mortgage loans @ 4%	+$20,000
S&L invests remaining $500,000 of deposits into U.S. Treasuries paying (-1%)	-$5,000
S&L loss	**-$5,000**

Depository financial institutions including S&Ls and banks cannot lend 100% of the funds that they receive from depositors. The S&Ls and banks must have funds available to provide to those depositors who decide to withdraw monies from their accounts. Banks are prohibited by regulators from investing their reserves into anything other than government guaranteed securities. For this reason depository financial institutions in the U.S. must be able to invest their reserves into secure U.S. Treasury securities that pay a positive yield. The centuries old banking model of banks investing their reserves into treasury securities works the same in all developed and emerging countries. A U.S bank or a bank domiciled in a country that does not have positive-yielding treasury securities into which the bank could invest its cash reserves cannot remain a bank.

What is now happening in Europe is a confirmation that negative interest rates pose grave risk to U.S. banks and banking systems. In 2014 the ECB instituted a NIRP for all of its European member countries, including Germany. According to the March 4, 2016, article entitled "It's a revolution: German banks told to start hoarding cash" published by *Sorveign Man*, cited in English "German newspaper *Der Spiegel* reported yesterday that the Bavarian Banking Association has recommended that its member banks start stockpiling PHYSICAL CASH [*sic*]." Members of the association are in an uproar about having to pay the ECB the 0.03% NIRP rate on un-loaned reserves of the banks. To make matters worse, in its March 10, 2016 policy meeting, the ECB increased the negative rate to 0.04%. In the press conference, held by the ECB at the conclusion of the policy meeting, two very disconcerting answers were given by ECB officials to questions from reporters. Both answers confirm that the European banking system is becoming increasingly dysfunctional. Answers by ECB officials to questions raised by reporters and my comments follow:

- The ECB Vice President explained that while the banks had lower profits resulting from NIRP, this was not a major concern because the banks had been able to book capital gains on bonds that they hold in their investment portfolios.

  Any bank or business having to depend on capital gains to subsidize a decline in operating profits or cover operating losses can only end in disaster.

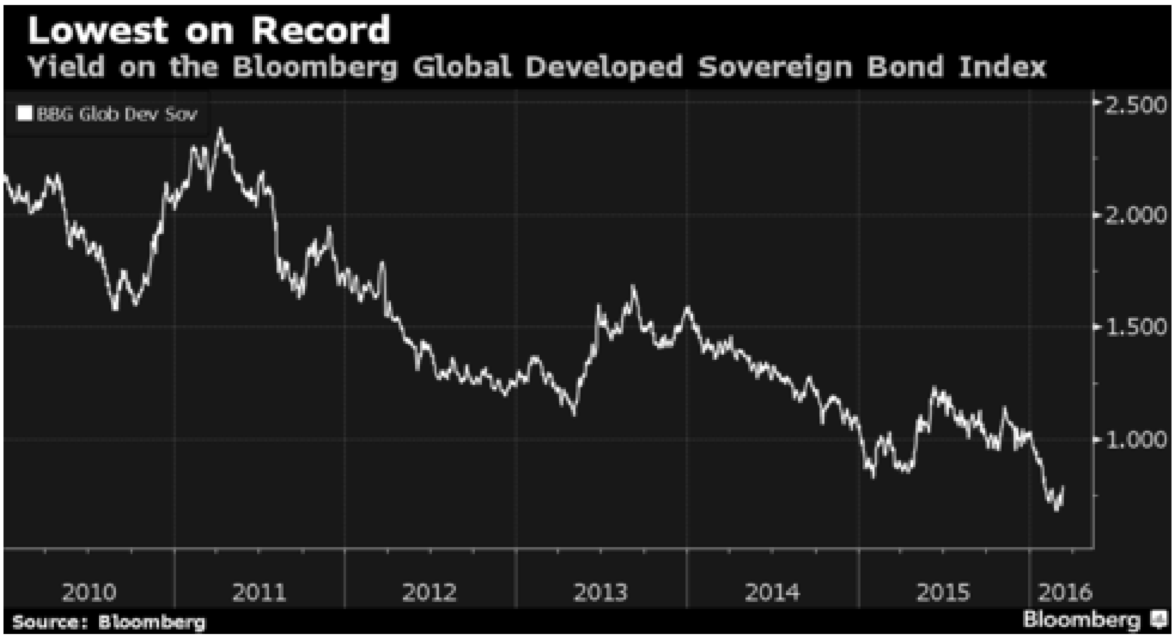
- A reporter posed a question about retail banks struggling with the NIRP. ECB President Mario Draghi's reply was that negative rates do not work for all banking business models.

  There are only two types of banks, commercial and commercial/investment. A commercial bank, which is also known as a "retail or a community bank" takes in checking and savings deposits and provides loans to local individuals and businesses. A commercial/investment bank is a hybrid, which can generate fees and commissions by raising "equity" capital for the larger private and public companies. J.P. Morgan and Deutsche Bank are both hybrid examples. For a commercial bank to also be an investment bank requires a license. Less than 1% of the more than 6,000 retail banks in Europe and more than 5,000 in the U.S. have licenses. It is now only a matter of time before the ECB's NIRP and negative interest rates erode Europe's banking system.

(The hoarding of cash by banks and also by individuals causes serious dysfunction within the world's banking system. Currency constitutes merely a small percentage of the world's money supply. If a fraction of the banks start hoarding currency it would cause significant stress on the banking system. The amount of cash that is in circulation is equivalent to a fraction of all banking transactions. Since hoarding by banks would remove the cash from circulation it would eventually lead to chaos and complete dysfunction for the banking system. To understand the huge risks to the banking system from individuals in Europe that have begun to hoard cash please see my March 9, 2016 article entitled "[Cash Hoarding has Thrust Negative Rates Into Lead Role for Next Crash]()".)

Demand for U.S. Treasury Securities Will Drive Interest Rates Below Zero

What the banks in Europe and Japan are now facing, and what I predict that U.S. banks will eventually have to face, is that the quantity and yields of positive-yielding government or sovereign-debt securities that will be available for purchase in the secondary markets or from new issues auctions are declining. Negative yields on German 2-year notes recently fell to a negative 0.57, and the yield of the 10-year German bund is now hovering at just above zero. The yields for all of Japan's notes and bonds of durations of 10 years or less went negative and have remained negative shortly after their central bank — Bank of Japan (BOJ) — announced that it was instituting a NIRP on January 29, 2016. Additionally, the yield for the U.S. 10-year Treasury notes have fallen significantly since the beginning of 2016, and was recently hovering just above its 30-year low of 1.44%. The chart below of the yields for Bloomberg's sovereign bond index graphically depicts what U.S. banks will soon have to face.



With yields for two of the three world's biggest issuers of government or sovereign debt securities going negative, the U.S. is now the only remaining major country that has government debt-securities with positive yields. This will soon pose a big problem for U.S. banks. Worldwide, investors are now competing against U.S. banks and U.S. investors to purchase the sovereign securities of the U.S. Treasury. This will result in the prices of the securities being driven upward and the yields declining, eventually becoming negative. After this happens, it will only be a matter of time before U.S. banks follow the rest of the world's banks and become dysfunctional. From the start of 2016, European bank stocks were down 27% as compared to 11% for the U.S. bank stocks. Below are the categories of buyers that compete to purchase U.S. Treasury debt securities:

- **U.S. Banks.**
- **U.S Federal Reserve Bank ("the Fed").**
- **U.S. Speculators.** These include the Treasury securities ETFs.
- **U.S. Institutional Investors.** These include the money market funds that have $1.4 Trillion of U.S. Treasury securities.
- **Foreign Investors.** Japanese brokerage firms have already started to create and sell funds that consist of U.S. debt and equity securities.
- **Safe-Haven Investors.** The world's wealthiest families, largest pension plans, endowments, etc. — with the majority having capital-preservation profiles and 100-year-investment time horizons

The only fail-safe solution available to investors to fully protect themselves from macro-economic risks is sovereign bonds issued by a safe-haven country. A government of a country that has the ability to tax its citizens to repay the debt, is the backing of all safe-haven bonds. The safest safe-haven countries are the U.S., Japan, and Germany. Greece is not a safe haven because Greece has tax-collection difficulties. The U.S. is a good example. After the Great Depression began the U.S. income tax rate increased to as high as 90%. U.S. investors need to understand that the securities of the safe havens of the U.S., Japan, and Germany are the "Lloyds of London" for the financial markets. Eventually, the positive-yielding sovereign securities (insurance policies) will no longer be available. For more on safe havens, please see my May 2009 "Safe Haven" white paper.

The depleting quantities of positive-yield sovereign or safe-haven bonds in the world are similar to the issue that I brought to light in my September 2007 *Equities Magazine* article entitled "Have Wall Street's Brokers been Pigging Out?". I emphatically told my readers to sell their shares of Lehman, and the other four leading brokers when the shares were trading at close to all-time highs. The basis of my "sell" recommendation was that I had concluded that the brokers had already depleted the pool of large institutional investors who could have potentially bought their subprime loan packages. The excerpt below is from my 2007 *Equities Magazine* article.

- "I believe that there will be a day of reckoning. It will be sooner rather than later and that day will be ugly for the five large brokers. An obvious question is just how many regular humongous buyers are there for the billions of dollars of the mortgage-backed and private-equity related securities that Goldman and the other four are creating, holding and trading? … I believe that these five big brokerage firms are going to hit that same wall. **It's only a matter of time."**

The pool of safe-haven sovereign debt, including U.S. Treasury securities, will soon be depleted. I am once again emphatic. This time I am advising my readers to sell all of their equity holdings. When I predicted the collapses of Lehman and the other four brokers in September 2007, I should have told my readers to completely sell everything else in their portfolios. After witnessing in 2008 the havoc caused by a U.S. banking system that would likely have failed without the aid of TARP, I will not make that mistake this time. There is not a doubt in my mind that positive-yield U.S. Treasury debt securities will soon no longer be available. When this happens the world's banking system and financial markets will have hit the wall. **It's only a matter of time.**

The writing herein is in further support of my February 26, 2016 foundational report "Japan's NIRP Increases Global Market-Crash Probability" which concerns NIRPs, deflation, and the potential devastating impact that both can have on corporate profits and on the markets. The report concluded that instituting of a NIRP by the BOJ had significantly increased market volatility to the point that it has increased the probability of a market crash. (My recommended investment strategy, which protects an investor's capital against significant market corrections and crashes, is contained in an excerpt from my foundational report entitled "Pre-Crash 'Black Swan' Investing Strategy".)

My foundational report also provides details on research that I had conducted on the Crash of 2008, which enabled me to discover the metrics that could have been used to predict the 2008 crash and the V-shaped reversal. These metrics are now powering an indicator (warning system) that I developed and named the "NIRP Crash Indicator". It is currently being utilized to monitor the markets for indications of any impending crash, and is freely available at www.dynastywealth.com.

My March 9, 2016 follow-up report "Cash Hoarding Has Thrust Negative Rates into Lead Role for Next Crash" is highly recommended. The video "Negative Rates Pose Risks to U.S. Markets" below is a discussion that I had with SCN's Jane King about the increasing risks for all worldwide banks and depository institutions that have been caused by the onset and spreading of negative interest rates.

My predictions are frequently ahead of the curve. The September 2007 predictions that appeared in my EquitiesMagazine.com column stated that share-price collapses of the five major brokers, including Lehman and Bear Stearns, were imminent. While accurate, they proved to be premature. For this reason I had to advise readers to get out a second time in my January 2008 column entitled "Brokerages and the Sub-Prime Crash". My third and final warning to get out, and stay out, occurred in October of 2008 after Lehman had filed for bankruptcy. For my article "The Carnage for Financials Isn't Over" I reiterated that share prices for the two remaining public companies continued to be too high. By the end of November 2008 share prices of both Goldman and Morgan Stanley had fallen by an additional 60% and 70%, respectively — new all-time lows.

About Dynasty Wealth Investing

As the co-founder of Dynasty Wealth Investing, an exclusive investing community, I am predicting that the decade ending 2020 will be recorded by historians as having been the best ever for investors to build dynastic wealth of 10- to 100-times investment from a diversified portfolio. There is a 6-minute video that provides details about Dynasty Wealth's investment philosophy and analytics. It also covers the industries and companies that have the potential to increase by 100% per year and by 10- to 100-times in value within five years.

Additional videos about producing dynastic wealth are available at http://www.dynastywealth.com/video.php. In-depth information about both my past and current predictions is available at www.michaelmarkowski.net.