Will Negative Interest Rates Ever Come to Canada?

Description

For a few months in Europe, something interesting was going on. Investors were paying central banks to borrow money, not the other way around.

The Eurozone let its floating rate for deposits dip into negative territory starting back in September. Denmark joined in—since its currency is pegged to the Euro—and it snowballed from there. Just six months after negative rates first hit the continent, nearly a quarter of debt issued by governments in the region had negative rates, including some long-term German and Swiss bonds.

These days, most European debt does pay interest, but only barely. The continent isn't far from going back to a negative rate scenario.

Here at home the situation is slightly different. Thanks to a decline in the bond market back in April, North America isn't anywhere close to having the same conversation about negative rates. Even if governments borrow money for as short as a few months, they'll still pay interest for it. There won't be much interest, but they'll pay it.

There's an argument to be made that negative interest rates could make their way across to North America, however. If the economy stumbles just a little bit, central banks don't have much room to cut interest rates in response. We're pretty close to zero as it is. And remember, Europe isn't the only place that's had negative rates. Japan has been stuck in a similar situation for years now. There's no reason to think Canada couldn't possibly join these nations.

If negative rates do come to Canada, here's how your portfolio would be affected.

More money into stocks

Value investors everywhere are lamenting the lack of opportunities in today's stock market. But there's a reason why stock valuations are high—there's simply no alternative.

When GICs and government bonds pay less than 2% annually over a five-year term, investors are forced to pay higher valuations when putting money to work. A stock trading at a 5% earnings yield looks pretty attractive next to a 2%-yielding GIC. It's the equivalent of buying a stock with a 10% earnings yield when GICs yield 4%.

Now, imagine what happens if government bonds pay negative yields. Suddenly, price-to-earnings ratios of 25 or 30 might look attractive, at least compared with the alternatives.

REITs will do well

Canadian REITs have sold off over the last few weeks mostly due to concerns that interest rates are about to head higher.

If rates reverse themselves and actually head lower, it'll be very good news for owners of REITs. As the yield investors feel comfortable with goes down, they'll bid up the underlying assets, so all things will stay equal. It's the same thing with bonds, just on a lesser scale because high-quality bonds already don't yield much.

If the yield for **RioCan** falls from 5% to 4%, shares will go up 20%, assuming the dividend stays the same.

Avoid the insurers

There's one group of companies that will not do well if negative rates come to Canada, and that's the insurance companies. Particularly, **Manulife Financial Corp.** (TSX:MFC)(NYSE:MFC) and **Sunlife Financial Inc.** (TSX:SLF)(NYSE:SLF) look weak in that type of environment.

Here's how the life insurance business works. Customers pay a monthly premium to the company, which then invests that money. Ideally, the insurance runs out and the company doesn't have to pay the insured a dime, but that doesn't always happen. As long as it can generate more by investing the premiums than it pays out, a life insurer is doing well.

But the insurer doesn't want to take a huge amount of risk, so the majority of its holdings will be held in secure assets—like government and high-quality corporate bonds.

You can probably see where this is going. If yields continue to creep down, it makes life a whole lot harder for the life insurance companies. They're either forced to take on more risk by investing in assets like stocks, or take less in profit. Neither outcome is ideal.

Should you worry?

I am a little concerned that negative rates could come to Canada, but I'm not doing much about it.

The easiest way for investors to prepare is to just keep buying high-quality stocks. Don't worry about stuff we can't control and just buy quality. It's that simple.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:MFC (Manulife Financial Corporation)
2. TSX:MFC (Manulife Financial Corporation)
3. TSX:SLF (Sun Life Financial Inc.)

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Date
2025/08/26
Date Created
2015/05/29
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