Closing The Book On ZIRP

Old habits die hard, if they die at all. As we come up on the seventh anniversary of the Lehman Brothers bankruptcy, let's ask for an honest show of hands for all of those who foresaw the Federal Reserve's emergency federal funds rate of 0-25 basis points adopted in December 2008 as lasting this long.

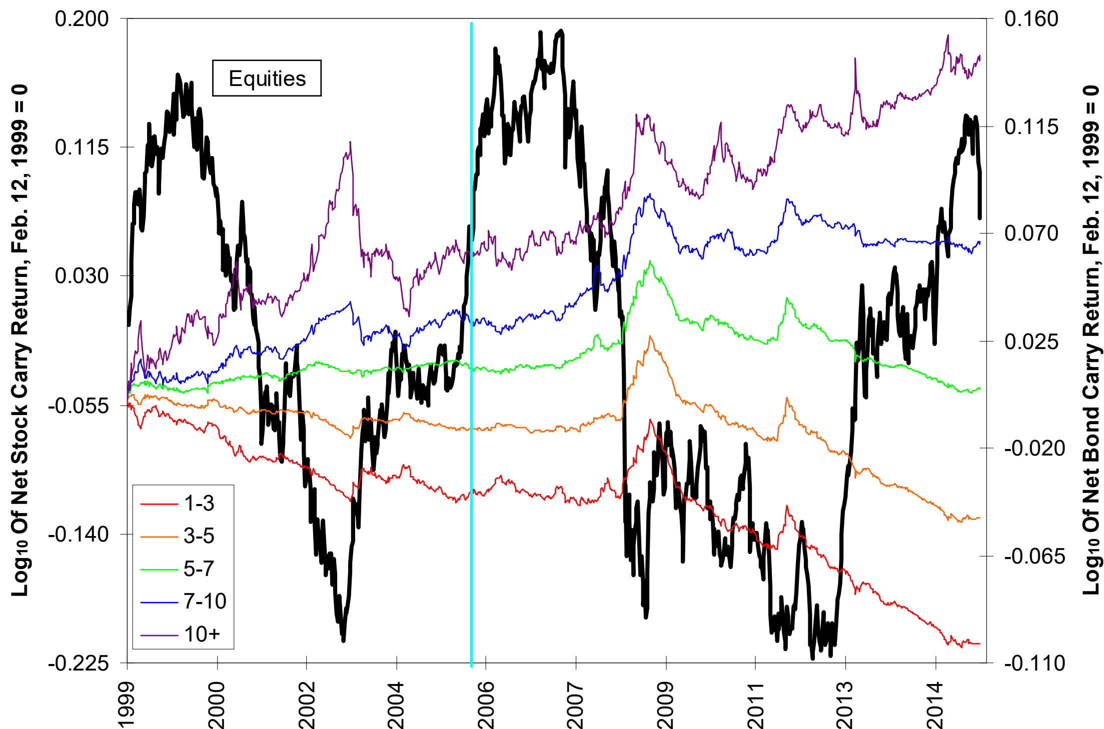
Once Ben Bernanke (remember him?) signaled in July 2009 this zero interest rate policy (ZIRP) would continue, its fate as a long-running part of the landscape was sealed. This was the Japanese experience as well. They went to ZIRP in February 1999 and reinforced it with their first round of quantitative easing in March 2001. These are generational numbers; it is safe to say no one below university age in Japan ever had the childhood experience of seeing interest credited to a savings account and enjoying life's first "money for nothing" experience.

Comparative Scorecard

If the ZIRP era in the U.S. is about to draw to a close, let's finalize a comparison between U.S. and Japanese capital markets compare over their respective ZIRP histories from February 1999 and December 2008. If we map net Japanese carry returns for stocks and bonds across various maturities, we can see net carry returns for Japanese government bonds of the 1-3 and 3-5 year maturities remain negative more than fifteen and one-half years into the ZIRP era, and net carry returns for 5-7 year bonds are barely positive.

A turquoise vertical line marks the comparable point in time since the U.S. adopted ZIRP in December 2008, now 351 weeks ago. The U.S. stock market at this juncture remains well above Japan's. In local currency terms, the U.S. has seen a net total return after carrying costs of 145.8%; Japan had a net total return of 15.4%.

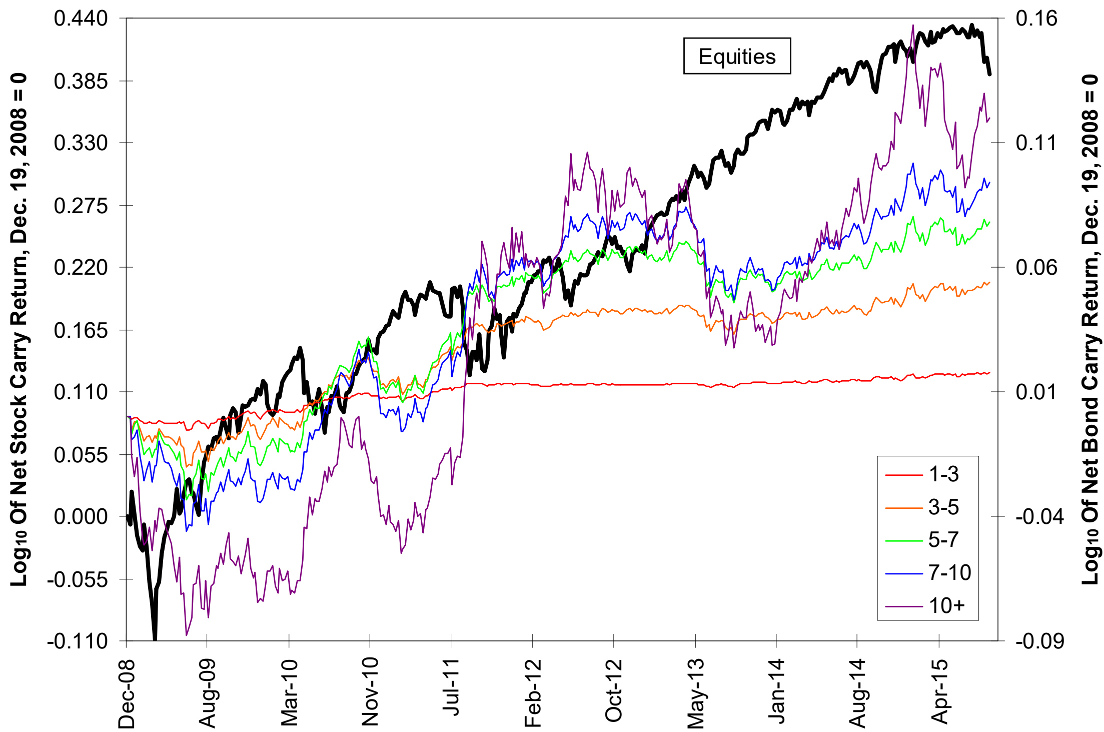
Japanese Capital Markets After Zero Interest Rate Policy Began



The net carry returns for U.S. bonds remain positive across all maturity segments. These returns retain the exaggerated effects of Operation Twist with the longer maturities gaining the most. U.S. net carry returns peaked at the end of January 2015 for all maturities of 5-7 years and longer. Net carry returns for the 3-5 year and 1-3 year segments peaked on August 21 and September 4, 2015, respectively.

It is telling net carry returns in Japan for all but the 10+ year maturity segment peaked in April 2009, more than ten years into ZIRP as net interest rate income and capital appreciation for JGBs could not offset funding costs for investors.

U.S. Capital Markets After Zero Interest Rate Policy Began



If the Japanese analog is any guide, higher short-term interest rates should start to lower net carry returns for U.S. Treasuries, especially for the 1-3 and 3-5 year segments. Whether this will translate into lower net carry returns for either long-term Treasuries or for equities remains to be seen. However, we would need to see both a continuation of a flat yield curve for a long period of time coupled with sufficient earnings growth to expect gains in long-term Treasuries and in U.S. equities, respectively. This, as the famous Japanese saying for "ain't gonna happen" goes, will be very difficult.