ADDING VALUE

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Central bankers around the world are pushing interest rates to never-never land, but the public is not cooperating with the stimulus. Are we nearing the end game?

IF AT FIRST YOU DON'T SUCCEED…

A milestone was reached in the first quarter of 2016. Economists used to think that below-zero interest rates were impossible. Now there is a name for it—NIRP. In 2009, Ben Bernanke stated: "No one will lend at a negative interest rate; potential creditors will simply choose to hold cash, which pays zero nominal interest." We now know he was wrong, at least with regard to Japan and most of Europe. Central banks there have instituted negative rate policies. The Fed is currently speculating about the possibility in the USA. Indeed, by the end of 2015, Bernanke was saying: "I think negative rates are something the Fed will and probably should consider if the situation arises."

THE KEYNESIAN THESIS

Keynesian economics believe that low interest rates always stimulate the economy. Reduced borrowing costs make it easier for consumers to buy houses and "stuff" and for companies to invest and expand. Lower yields on savings cut the incentives for consumers to stash their cash in banks and make them more inclined to go out and party. As recently as 2006, the annual income generated by a $100,000 investment in a 6-month CD was $5,240. In 2015, your annual income had dropped to $370. In 2016, even with super-duper "special" bank programs, you can probably only earn about $250 in the US.

In more technical terms, as a lender, I get paid interest to compensate me for the uncertainty of the future. The lower the current rate of interest, the less incentive I have to lend, and the more I should consume today. As a result, lowering interest rates tends to bring forward consumption to the present. Conceptually, therefore, cutting interest rates should lead to a higher level of economic activity today, to be paid for by a lower level of activity at some point in the future. In essence, this has been the Fed's plan since it tried to shake the US out of the doldrums of a severe recession in 2009; keep lowering the return inexorably on less risky assets ("bonds") forcing investors into the stock market and into shopping malls. That is a fine action plan, except of course that an abnormally low rate of interest acts as a tax on the poor who save, for the benefit of the asset-owning rich.

ADDING VALUE is mailed and posted on our website quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research.

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BE CAREFUL WHAT YOU WISH FOR

However, if interest rates are pushed into negative territory, we have a totally new ball game. If interest rates are really there to compensate me for an uncertain future, then the future is more certain than the present with negative interest rates. Say, what? This is idiotic. The future cannot be more certain than the present. So in this upside-down world, what might we see happen?

1. Under negative deposit rates, buyers would want to pay their invoices as soon as possible. Think about your credit card bill. If you normally spend $10,000 a month, your best move would be to send the bank that much money before you spend it, then draw down the resulting credit card balance.

2. Cash hoarding ("the Mattress Idea").

3. Special purpose banks could be another new financial innovation. You would open a checking account (for a fee) at the institution which promises to hold only cash (which it immobilizes in a very large vault). This is slightly less risky than the mattress idea because you would be protected against robbery and fire, and you would be willing to pay a fee for this "insurance".

4. The government (Central Bank) could eliminate physical cash. Denmark, Sweden and Norway are already considering ways to do this.

5. The Central Bank could get rid of large denomination bills. You need much more space for smaller bills. Think of the thickness of a wallet stuffed with a few $100 bills versus hundreds of $1.00 bills.

6. Milton Friedman/Ben Bernanke could institute their policy of "helicopter money". Just like it sounds, this is a program where central banks distribute money directly to all the population in what can be called a "citizen's dividend".

As we searched for another way of explaining negative rates, we realized that it has been going on for a while in consumer products. Ever wonder why you are still hungry after eating a bag of the newly "improved" potato chips? Manufacturers have been adopting this practice for years now. Increase the size of the bag and the air in it, and decrease the physical content. Keep the original price. The weight of the content has shrunk but the price has stayed the same!! That is what will happen to your bank account with negative interest rates.

This isn't some alternative universe, but actually what is happening in Europe and Japan today. But the boom that the central bankers predicted by implementing this policy is nowhere in evidence. In a complete opposite direction of what classical economics teaches, low costs of money actually have induced Japanese and European consumers to spend less. Around the world, people are reacting to zero interest rates by saving more. Financial repression that has depressed rates to levels that are unprecedented in history is having unpredictable effects. This behavioral dimension helps explain the tepid payoff from taking interest rates to zero and below. As Yogi Berra is quoting as saying: "In theory there is no difference between theory and practice. In practice there is."

TRY, TRY AGAIN

Granted, this is ALL still theoretical in the USA today. First, in the USA the law authorizes the Fed to pay interest on excess reserves but may not give it authority to charge interest. The legality of negative interest rates did come up in congressional testimony recently. Janet Yellen's, the current head of the Federal Reserve, response was:

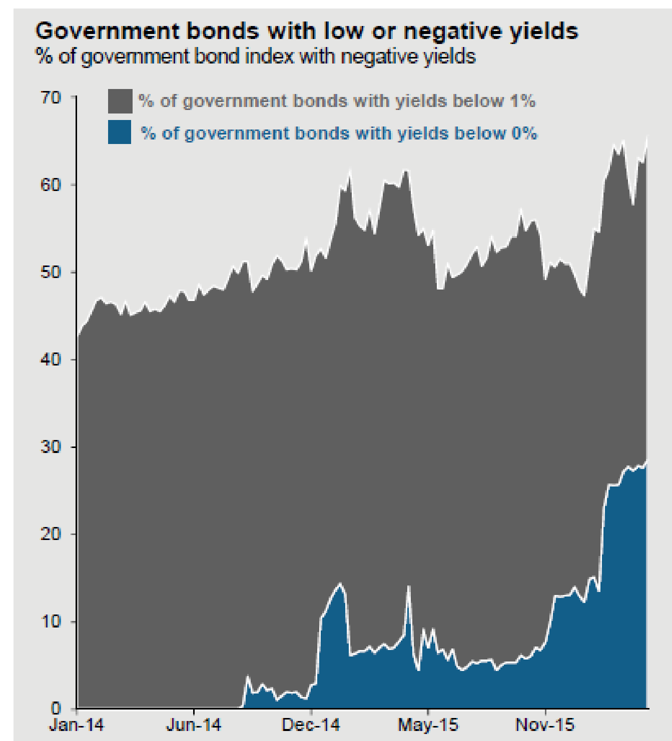
"In the spirit of prudent planning we always try to look at what options we would have available to us either if we needed to tighten policy more rapidly than we expect or the opposite. So we should take a look at negative rates. The legal issues I am not prepared to tell you have been thoroughly examined at this point."

The fact that this a "monumentally" bad idea doesn't mean that it will never happen here. But we don't know how deeply negative rates would have to go before people change their behavior and the time it would take to adapt to the new practices. We started our careers in the mid-1970's when inflation was out of control. Hard to believe, but the "prime interest rate" was 20% (a far cry from negative rates). Few could finance a home with traditional methods. A homeowner who would agree to owner-financing were the only ones selling their houses. The Financial Accounting Standards Board (FASB) brainstormed and introduced revised methods for corporate balance sheet presentations, so that fixed assets could be adjusted for inflation. Forget hoarding. There were street corner money lenders in South America who would change your currency multiple times during the day so that you could avoid major devaluation <u>on the money that was in your pocket</u>. Here we are 35 years later thinking about hoarding cash. The market has done a 180° turn. Insane inflation to equally devastating deflation. Wow, we have come a long way, baby!

The problems posed by negative rates are mostly practical in nature (sort of like Y2K), but they come with some deeply disturbing side effects. Some of the side effects include:

1. The problem of misallocation of capital;
2. The negating of Schumpeter's creative destruction cycle;
3. The even more intense repression of savers and retirees; and
4. The absolute devastation negative rates would wreck on pension, endowment and insurance company portfolios.

Companies in the USA have taken advantage of low interest rates to issue record levels of debt over the past few years to fund buybacks and M&A. As Goldman Sachs Equity Research reported in November 2015, "This has driven the total amount of debt on balance sheets to more than double the pre-crisis levels. However, cash flows have not kept pace, resulting in leverage metrics that are the highest in 10 years." If interest rates go up, perfectly good companies could have some big bills to pay. This is the type of data that investors should be focusing on rather than being fooled by phony non-GAAP earnings adjustments, stock option accounting and stock buybacks that paint a false picture of corporate health.



Government bond index is the BofAML Global Government Bond Index. JP Morgan Guide to the Markets – U.S. Data are as of March 31, 2016.

Today, 30-40% of developed bond markets have negative yields and 75% of Japanese bonds do. Still, who cares? Just buy high yield bonds

or even stocks to avoid the trap. No! All financial assets are ultimately priced based on short-term interest rates (it is the foundation of the Capital Asset Pricing Model). Unless these low interest rate policies start to work and reflate the growth of the economy from stall speed, even stock investors will earn much less than historically. Investors cannot make money when money yields nothing.

Low interest rates have an outsized effect on certain industries whose business models with long term liabilities rely on 7-8% returns. Insurance companies, pension plans, endowments cannot cover their claims as conveniently as they could in the past because they cannot earn as much on their bonds and stocks. Because of Central Bank government policies, these companies cannot earn enough to cover the promises made. The damage extends to all savers; households world-wide that saved/invested money for college, retirement, long term care, medical bills, etc. will encounter problems.

In 1980, Volcker started the process to break the back of inflation. Today, FASB regulations on inflation-adjusted financial statements collect dust in some library and the booths of money changers have been packed away. We may need to find another white knight in 2016, this time to break the back of deflation.

The million dollar question today in 2016 is what should one assume going forward? Has the Fed permanently impacted the valuation of the stock market preventing mean reversion to occur in the fashion that we would have expected? We have spent a lot of restless/sleepless nights pondering this question . The answer affects every client portfolio. Betting on the Fed's ability to generate continued market levitation seems like a dangerous game, but it is the only way to outperform the S&P 500 Index in the current state of affairs. During most of the first quarter, we still got validation that the portfolios will out- perform on the downside and the diminishing impact of monetary policy on valuation metrics will begin to foster greater interest in the active management style that we implement. In this crazy, up-side-down world of low growth, negative rates and mega intervention, we think it is still better to be safer, than sorry!

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