MONEY FOR NOTHING?

WHAT TO MAKE OF NEGATIVE INTEREST RATES

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In a "normal" world a borrower pays a lender for the use of money in the form of interest. So, what are we to make of the fact that something like 17 trillion dollars or 30% of the world's investment grade debt now has negative interest rates, meaning lenders pay borrowers to take money. Is this because borrowers expect deflation, which would make the loan worth less when it is paid off than it is worth today? Is the risk of default zero so lenders don't have to be compensated for any risk? Maybe for the German government, but also Ireland, Portugal and Slovakia? Or, is there so much cash around that it has no economic value, i.e. a borrower can't expect to do anything productive with it so he has to be paid to take the money?

The history of negative interest rates is short but not very sweet. In the 1970s the Swiss tried to stem an avalanche of money from pouring into the country to escape rampant worldwide inflation by charging as much as 42% on foreign deposits. That wasn't enough because the Swiss Franc appreciated 70% against the dollar. Negative interest rates didn't deter speculators from making a killing on the Swiss Franc, but it did plunge the county into a deep recession.

Ignoring the lessons of the past, Sweden instituted negative interest rates in 2009, followed by the European Central Bank in 2014 and quickly followed by Japan and then Korea. Policy makers thought it was a good idea to reward borrowers and punish savers to an unprecedented degree. Not surprisingly, the actual effect has been the exact opposite of what the central banks intended, just as it had been forty years earlier. Borrowing decreased not increased, and the economies contracted.

What does this say about the state of the world economy? We're afraid, not much good. While we can cheer the fact that investors now apparently believe that inflation is dead, deflation is a rarer but much more devastating condition, generally associated with extreme deterioration in economic activity.

In theory, when a country lowers its interest rates it becomes less attractive for foreigners to hold its currency. The currency should depreciate on the international markets, making its goods cheaper and its exports more attractive. In theory, the resulting stimulus that will come from rising exports should pull the country or continent out of its funk and away we go. Except what happens if everybody lowers their interest rates so no competitive advantage is possible. Then what?

We know that persistent negative interest rates are a sure sign of a sluggish economy. The fact that they are so widespread indicates that economic stagnation is widespread. Just look at where they took hold, the morbid economies of Europe and Japan. That the president has asked the Fed to follow Europe and Japan down this road is puzzling, to say the least.

So, now the real question: What are savers and investors to do?

First, what not to do. Don't chase yield. Nearly every really bad investment was based on a high yield but a terrible total return. High yields in a negative interest rate environment should be a red flag. Is that dividend being earned. If not, they are paying you back your money, not making it for you. Why does the company pay a high interest rate on its bonds instead of borrowing at ridiculously low bank rates? Chances are the banks think the loan is too risky, and maybe you should too.

Don't try something new. In every credit cycle unscrupulous hucksters attempt to sell something new that promises yield and safety in a shiny new package. Of course what goes on underneath the surface to produce these fantastic results is too complicated for most investors to understand, too new to have a track record and too good to be true. Variable annuities have been repackaged to sell to the unsuspecting, not because they offer better returns after their nose bleed fees, but because they are the ultimate example of smoke and mirrors in a glossy folder.

Don't lower your standards. If you start by saying: "I need to make 6%," you are asking for trouble. You should say, "I need time tested investments that will give me the best return available." This is no time to lower credit quality, extend maturities or sacrifice liquidity to try to get an artificially prescribed return. Preferred stocks are hot again as investors chase yield. What most people don't understand is that they are really long term bonds and their credit risk is higher than junk bonds because they rank below banks and bond holders in credit covenants.

What investments perform best in a negative interest rate environment?

Long Term Government Bonds have seen massive price appreciation as interest rates fell, but wait! That price appreciation is past history. Today you are getting a tiny yield with very little chance of price appreciation and the real danger that losses could be massive if/when interest rates get back to normal.

Commercial Real Estate is generally a highly leverage investment. All the more today when over 70% of commercial real estate loans are interest only with interest rates as low as 3-4%. Suddenly it makes perfect sense to buy a building for just a 5% return on purchase price when you can leverage that 1 or 2% return at four to one. A no brainer until that floating rate loan starts floating up, and anyone who wants to buy your property needs a more traditional 7-8% cap rate

Equities because corporations are net borrowers. That's a good thing when money is almost free. They are also net renters, so they benefit when land lords aren't demanding higher rents. They generally pay dividends and I've never heard of a negative dividend, so stocks should be worth more as interest rates decline. In fact with the dividend yield for the S&P better than the yield on a US ten year bond, stocks look cheap by comparison right now.

But what about profits? Ultimately we price stocks at a multiple of earnings. We could certainly argue that in a period of extremely low interest rates the multiple to earnings that investors are willing to pay should go up. After all, if I can get something that is growing by even 6 or 7% when everything else is stagnant, it should look pretty attractive. That is, if we can avoid a recession. What are the chances of that?

Keep in mind that negative interest rates were not caused by the market. Nobody demanded they get paid to take out a loan. Central banks decided to impose negative interest rates in an attempt to stimulate the economy by expanding credit and punishing savers. But, to then assume that the totally artificially induced negative interest rates and inverted yield curves are foretelling a recession is illogical. Negative interest rates were devised to avoid a recession, not cause one.

Still, we do know there are some policies that we are dangerously close to implementing that can cause a recession. A major disruption in world trade being the most likely at this point. On that point we are cautiously optimistic despite new tariffs and an apparent lack of understanding on both sides of the trade wars and Brexit. The market understands.

Fear what the market doesn't fear

To really get into trouble you have to fool the market. Back in the seventies and into the eighties we created hyperinflation by following a policy of running huge deficits to pay for the war and the market didn't care until one day we woke up to double digit interest rates. It took Paul Volker and the Fed to fix it before the whole financial system collapsed. Volker had an ally in his mission, a mythical group we named the "bond vigilantes." Every time the vigilantes saw a policy that was at all inflationary they punished bonds. Of course it would have been better if they were more active when the US was spending like a drunken sailor, but the point is we got into trouble by fooling the market and the market fixed it by demanding better policy.

The same was true in the 2000 stock market crash. The market was fooled into believing that tech companies could change the world, until we found out they couldn't and suddenly we had to revalue a huge percentage of the market. That was followed by the great Ponzi scheme of 2008 when the banks and other financial institutions were printing fake money using 30 times leverage on risky assets, but again, the market was fooled until it wasn't, and punished anything that had to do with risky assets and leverage. What should have happened in each of these disasters was that before they grew to the proportions that they could destroy the world economy, the market should have imposed discipline.

What is heartening about today's trade war is that the market gets it. Every time there is an escalation of trade tensions the market drops, making it absolutely clear to policy makers what the consequences will be if they go much further. Let's call them the "Stock Vigilantes." How long before the policy makers figure this out? We have an election coming up, probably so does Britain and China has a 70th birthday party. Nobody wants the Vigilantes to spoil the fun. Which isn't to say that they won't purposely cause the next recession, but if they do, it will be the first time that world leaders were warned that their policies would cause grave economic harm and followed them anyway.

So, negative interest rates are definitely a sign of a sluggish world economy, but not necessarily an indication that we are in, or about to be in a recession. That leaves investors with the classic decision of where to put their money. History and logic says that equities provide the best return over time.

Leaving the questions: "How much time? And exactly what return?"... unanswered. Sorry about that, but we can only say that historically equities outperform all other assets something like 90% of the time over any ten year period. And, given that bond and cash yields are low to negative, it wouldn't take much to beat that. Real estate and gold work best when there is inflation. None of that to be seen. That leaves the stock market as your best option, with enough of your portfolio in bonds and cash to weather any storm that might be on the horizon.

There will be a recession, it will just most probably be caused by something almost nobody saw coming, just like all previous ones. Sorry again, but that's just the way the economy and markets work. There are plenty of charlatans, cowards and fools out there who will tell you they can predict when and how severe the next market correction will be. One of them will be right; we just don't know which one.

The right thing to do is to accept the fact that recessions and market corrections are unpredictable and act accordingly. Always assume the next downturn is just around the corner. Know that as your advisor, we will not panic. Know that we have anticipated the event by having a balanced portfolio of defensive stocks, bonds and cash that will not force us to sell at depressed prices. Know that we have been through this many times, and each time the end result was that we bought great companies at bargain basement prices, which now show huge gains in our portfolios.

That's what prudent investors do when the yield curve is as steep as Mount Everest and even when it inverts.

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