The Twilight Zone

July 2016

You are traveling through another dimension, a dimension not only of sight and sound but of mind. A journey into a wondrous land whose boundaries are that of imagination. Your next stop, the Twilight Zone! - Rod Serling, ca. 1959

Imagine a world where central banks move beyond their Earthly mandates of maximum employment, stable prices, and moderate long-term interest rates, into a world where they actively participate in manipulating both equity and fixed income markets. Imagine a world where investors buy fixed income securities from governments, but with a twist! Not only do they not receive interest payments for lending their money to the government for up to 50 years — they actually *pay* the government to hold their funds.

Imagine, if you will, a world where some of the largest economies in the world issue new debt with *negative* interest rates -- a world called NIRP.

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NIRP

NIRP (Negative Interest Rate Policy) is a relatively new monetary policy tool in the toolboxes of global central banks (CBs), like the Federal Reserve (FRB), the European Central Bank (ECB) and the Bank of Japan (BOJ). It exists when the CBs formally set policy interest rates at a negative value.

In the U.S, the policy rates are: the *Interest On Required Reserves* rate (IORR) which is paid on the funds that banks are required by law to hold in reserve at the Fed, and the *Interest On Excess Reserves* rate (IOER) which has historically been paid on any additional funds banks held at the Fed above the required amount. The Fed also sets the *Federal Funds* rate (FFR) as a target for overnight lending between banks of their own excess reserves to banks who may need short term funds to meet the Fed's reserve requirements.

Because commercial and retail banks set many of their lending rates based upon CB policy rates (and the Fed Funds target rate in the U.S), such a policy has significant implications for monetary policy, bank lending, consumer savings, borrowing and spending, and general economic activity.

The primary purpose of NIRP is to induce banks to lend excess reserves by charging them a fee (by way of a negative interest rate) rather than maintain unnecessary, excess reserve balances with the Fed. It is hoped that banks will find it preferable to lend to consumers and businesses rather than incur a cost on their excess funds. It is also hoped that banks will lower their lending rates to spur increased borrowing and investing.

Additionally, CBs can temporarily set negative rates to provide a disincentive to foreign investors making local deposits. Switzerland ran such a program in the 1970's to counter unwanted currency appreciation in the Swiss Franc caused by investors fleeing less stable countries. Similarly, Sweden (in 2009, 2010 and 2015) and Denmark (in 2012) used NIRP to limit such currency flows into their own markets.

More recently CBs have begun a third approach, using NIRP as a policy tool to ward off deflation (a downward spiral in inflation and general prices in an economy), which the ECB (2014), and Japan (2016) implemented to thwart chronic economic weakness and a deflationary environment.

QE and NIRP

The predecessor to NIRP was the aggressive lowering of policy rates (in many cases to zero) implemented by all major CBs following the Great Recession of 2007-2009. CBs and many economists widely expected an increase in lending, spending and investments to follow. However, banks that were still reeling from bad loans, consumers "upside-down" on their mortgages, and businesses with weak sales prospects had little stomach for new debt, resulting in tepid economic growth.

In an effort to jumpstart their economies, many CBs implemented another new policy tool called Quantitative Easing (QE). Originally, QE allowed CBs to buy bonds on the open market (effectively removing them from service) with the goal of driving up their prices and lowering the yield on comparable instruments. Initially, CBs limited their purchases to the bad debt being shouldered by the banks or the short term sovereign debt of their own countries. More recently, the ECB and BOJ have expanded QE to include the purchase of corporate bonds, and even junk bonds, stocks and ETFs.

As a result of the price-insensitive CB purchases, sovereign bond prices soared and yields have commensurately collapsed, as we can see in the chart to the right. As the availability of the high quality, "risk free", sovereign debt targeted in QE programs declined, sovereign yields began to turn negative (below).

The Matrix: Race to Negative Bond Yields

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-0.87	-0.90	-0.94	-0.90	-0.87	-0.78	-0.73	-0.61	-0.51	-0.45	-0.19	-0.07	0.08
Japan	-0.26	-0.24	-0.24	-0.25	-0.24	-0.24	-0.24	-0.22	-0.18	-0.13	0.01	0.22	0.30
Germany	-0.53	-0.55	-0.56	-0.51	-0.42	-0.38	-0.31	-0.23	-0.10	0.03	0.13	0.36	0.63
Austria	-0.50	-0.50	-0.44	-0.42	-0.39	-0.22	-0.16	-0.07	0.09	0.23	0.31	0.81	1.07
Netherlands		-0.49	-0.46	-0.42	-0.25	-0.23	-0.11	-0.01	0.13	0.25			0.75
Belgium	-0.51	-0.49	-0.46	-0.41	-0.35	-0.25	-0.14	0.12	0.28	0.43	0.81	0.90	1.34
Finland	-0.52	-0.48	-0.45	-0.33	-0.28	-0.12	-0.06	0.03	0.17	0.34	0.58		0.78
France	-0.50	-0.44	-0.40	-0.33	-0.20	-0.14	-0.03	0.09	0.25	0.39	0.75	1.04	1.22
Sweden	-0.50	-0.63		-0.52	-0.33		-0.06			0.30		1.06	
Denmark		-0.40			-0.17	0.31				0.29			0.74
Ireland	-0.18		-0.31	-0.15	-0.07	0.12	0.30	0.50	0.66	0.73	1.09		1.59
Italy	-0.15	-0.06	-0.01	0.19	0.40	0.59	0.79	1.00	1.21	1.38	1.71	2.04	2.43
Spain	-0.16	-0.10	0.00	0.24	0.45	0.49	0.73	1.09	1.24	1.42	1.82		2.57
United States	0.57	0.76	0.91		1.21		1.49			1.68			2.48

Pension Partners

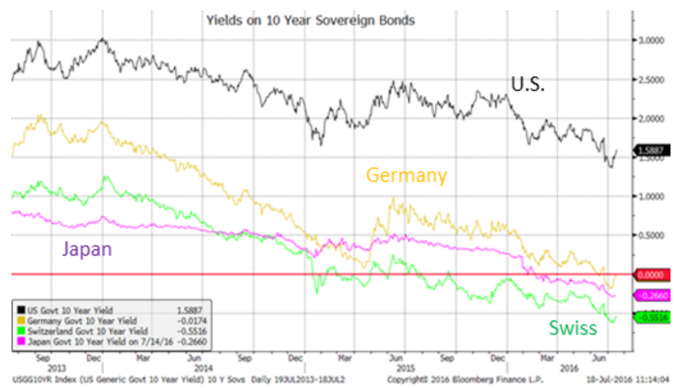
https://pensionpartners.com/there-is-no-impossible-in-markets/

Finally, as investors continued to move out the maturity curve and crowd into <u>all</u> "risk free" sovereign bonds, not just QE targeted bonds, the negative rate impact began to spread into longer dated maturities; even out to nearly 50 years in the case of Swiss debt. Today nearly 45% of the outstanding global sovereign debt, $11.7 trillion worth, carries a <u>negative</u> rate, with the US now accounting for almost 60% of all positive-yielding global debt, and 33% of positive, investment grade yield. At this rate we'll soon be the only game in town and then the fun really begins.

Chasing Yield

Central banks have lowered rates well over 600 times since the Great Recession, as one-after-the-other QE programs were implemented across many of the largest economies, with NIRP succeeding them, in an effort to spark growth. The economic impact has apparently been wanting, or we wouldn't need a continued morphine drip of monetary ease to sustain us for so long.

As global sovereign yields have fallen dramatically across the curve, and across all countries, so have yields on everything from Investment Grade (IG) corporate bonds, municipal bonds, junk bonds and CD's to money market funds as investors have frantically tried to maintain their income requirements.



This phenomenon is known as 'chasing yield', and has been seen at prior inflection points as investors ignored prudent risk profiles by actively extending into lower-rated, longer-dated securities just to maintain an acceptable level of income. Those who actively bought ARCs, REITs, preferred stocks and junk bonds just prior to the Great Recession were devastated by the subsequent spike in rates, and super-bear market in all-things-interest-bearing, as the lending debacle unwound. Surely they wouldn't succumb again?

And yet, we currently see private investors across the globe searching desperately for anything with a decent yield given the damage done to the yield profile of high -quality and sovereign securities. Perhaps unknowingly, they extend, and extend again, the maturity profile of their bond portfolio, seemingly oblivious to the incremental degree of risk and volatility they are assuming given the current generational low levels of yields.

Banks are similarly stuck, by regulations requiring them to increase and maintain capital buffers by holding high quality bonds. Likewise, there are pension funds who need longer-dated income producing, lower volatility, assets; and insurance companies who need to balance longer-dated liabilities with matching funding sources. Everyone is chasing a shrinking pool of qualified bonds.

Unintended Consequences

While CBs have operated under the assumption that banks would lend, consumers would spend, and businesses would invest according to plan, the results have been less than optimal. In some nations, particularly Japan, we have seen a *increase in* savings and an uptick in gold purchases, as well as a hoarding of cash, with sales of home safes and vaults soaring. The growing global concern, especially among retirees, is that savers are being punished and speculators rewarded, with the paltry yields on CDs and bonds impacting the former, causing them to have to save *more*, and spend *less*, to maintain their lifestyles.

As for the latter group, there are growing global concerns that new asset bubbles in housing, commodities, equities, and bonds have formed due to the cut-rate cost of capital. In periods where interest rates seemingly fail to fully reflect the risk associated with a given investment, we have seen more allocation to speculative investments and asset classes. In addition to an expansion in merger and acquisition activity, low cost access to funds through bond sales has resulted in an explosion of stock buybacks (which boost earnings), over the last several years, at a time when corporate spending on infrastructure and capital investments has waned. Despite this, S&P 500 earnings declined 7% in 2015 and are estimated to fall about 4.7% this quarter.

We have also seen growing concerns about the unintended deflationary impacts of both QE and NIRP-related policies, especially in China, Europe and Japan. As deflation takes hold, and general prices continue to decline on weak demand, poor pricing flexibility and a worsening employment situation, the impetus for consumer spending shifts; from buying now to buying later at lower prices—or not buying at all.

As firms fight for shrinking sales, governments have an incentive to lower their sovereign rates further, to weaken their currencies and make their exports cheaper on a relative basis. As a result, a low grade currency war has broken out between China, Japan, the EU and the US, with other countries, especially in the emerging markets, experiencing significant collateral damage.

Finally, by actively pursuing QE and NIRP, some observers view the Fed, ECB and BOJ as unintentionally removing the urgency that should be felt by politicians to put in place fiscal policies and reforms to rejuvenate their economies. Such an approach may have even unwittingly contributed to the tepid recovery from the Great Recession, now going on 10 years.

Client Impact

Curiously, investors have been willing to accept built-in negative returns if held to maturity because they believe deflationary forces will accelerate moving forward, and interest rates will become even more negative, so the dollars they will be repaid in the future will be worth more than dollars held today. And while new-issue negative interest rate bonds are <u>guaranteed</u> to lose principal in a flat rate environment, a rising rate environment would be even more disastrous than for “normal” bonds. In a rising, positive rate, non-deflationary environment, who would want to buy bonds with negative yields and no coupon?

Figure 5: Importance of US IG corporate bond market relative to the global IG broad market

Source: BofA Merrill Lynch Global Research

Instead, for many investors there is a temptation to extend maturities of “normal” bonds, by reaching further out the yield curve, to maintain an acceptable income flow. But longer maturities mean higher duration (sensitivity to changes in rates) and higher volatility. In the event of a bond shock, like what happened in the latter half of 2014, an unexpected, sharp move up in rates could cause significant losses in principal within longer-dated bond holdings.

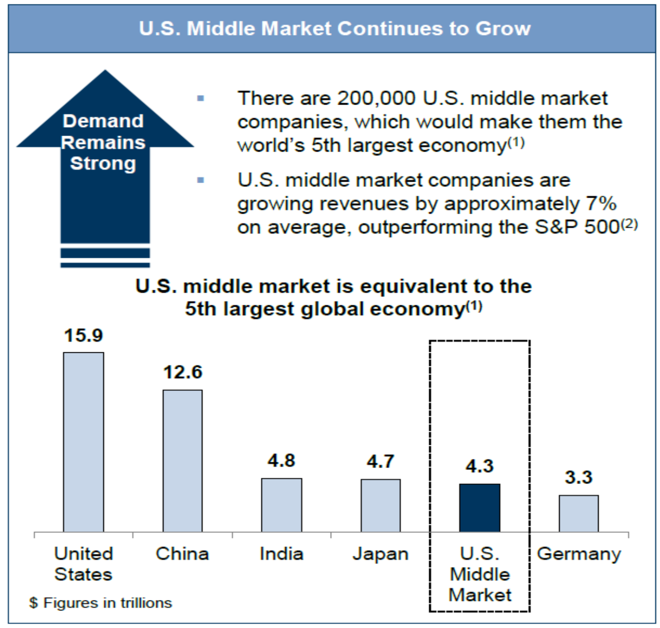
Recognizing this, investors will sometimes shift dollars to other asset classes within their portfolios; for example moving from bonds into dividend paying common or preferred stocks, without acknowledging the significant increase in volatility and potential for capital loss that may accompany such a move. This potential for a creeping risk profile may end up negatively surprising more conservative investors if we slide into a global downturn and equity-oriented assets come for sale.

The challenge for most fixed income investors is the diminishing amount of acceptable, high quality or sovereign debt available, especially in Europe. Beyond individual investors, at some point the ECB may quite literally run out of bonds to buy to implement their QE programs and NIRP policies. Then what?

The Legacy Solution

The landscape for fixed income investors looking for acceptable yield has become increasingly dire since the 2008 financial crisis, causing many to venture outside familiar borders. In addition to QE and NIRP, there have been sweeping changes in banking regulation (Basel III and Dodd Frank legislation) which have further constrained traditional lenders by increasing cost and capital requirements, creating a shortage of lending options. This has significantly reduced banks' ability to provide loans to those "middle market" companies increasingly shunned by the larger banks. Fortunately, this has created an extensive lending opportunity for firms that have the requisite skill to identify potential borrowers and conduct the appropriate due diligence to ensure the payment of principal and interest.

We have spent considerable time researching seasoned middle market lending funds, that are by design structured to provide greater investor safeguards, more conservative capital structures and regular coupon payments, and deliver attractive cash flow to their investors. Middle market lenders are often smaller investor groups, who actively participate in the loan, and therefore have an inherent interest in ensuring the success of the underlying credit, and not just the repayment of the loan. Their current yields are attractive relative to the underlying credit risk of the loans and default rates have historically been low.



(1)Source: CIA World Fact Book. As of September 30, 2015

In the brave new world of NIRP, it will undoubtedly require more than a traditional "buy and hold" approach to fixed income for investors struggling to maintain their required income streams. It will be increasingly important to explore alternative and creative means of identifying income assets. In the months ahead we will discuss several other non-traditional sources of income that we have identified, researched, vetted, and added to our investment arsenal on behalf of our clients.

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Now What?

Investors continue to dramatically penalize earnings shortfalls, and 2016 GDP estimates continue to fall. We remain cautious on equities for now and recommend maintaining modestly higher cash positions. We maintain our underweight positions in small caps, international and emerging market equities for the foreseeable future. We also maintain our positions in high quality, medium duration bonds, and remain cautious on weightings to high yield bonds and interest rate sensitive securities.

If you would like more information please contact us at 954 809-6363.

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