ECONOMIC OUTLOOK

bounty management

unique investment insight

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The Topsy Turvy World Of Negative Interest Rates

As if 0% interest rates were not bad enough, by early March, around 25% of global sovereign debt (roughly $8 trillion) traded at yields below 0% after central banks in Europe and Japan either initiated or extended forays into negative interest rate policy. Once isolated to unique situations like Switzerland, Sweden, and Denmark, even Federal Reserve Chair Yellen indicated in February rates below 0% are not off the table. Negative rates turn the financial world topsy turvy: bond purchasers pay interest to the issuer or the bank. The intent of low or negative rates is to stimulate economic growth by increasing bank lending, consumer demand for interest-sensitive goods (e.g., auto loans/sales), and investor and business sentiment. Consumer and business borrowing should increase, lifting demand, output, and employment in a upward cycle, lowering deflation risks in the process. While in theory negative interest rates are a logical extension of normal central bank policy, this is uncharted territory.

Similar to zero percent interest rates, negative interest rate policy aims to shift investor portfolios into riskier assets. With long-term yields on many "safe" government bonds below zero, investors must choose between locking in a loss, moving out along the risk spectrum by buying riskier investments, or reducing risk altogether. In practice, it is not at all obvious that aging populations across the developed world can or will reallocate into volatile equity markets. Instead, moving to cash or absorbing small loses in a low inflation environment can be a rational response. This can become a problem if people save more and spend less to make up for lost interest income: demand and inflation may move lower, not higher. If households fear that penalty fees on deposits are in the pipeline, a 0% return on cash looks comparatively lofty. In Japan, sales of safes soared 250% after the Bank of Japan introduced negative rates for banks with deposits held at the central bank. If households fear that penalty fees on deposits are in the pipeline, then a 0% return on cash looks comparatively lofty.

For businesses, zero or negative rates may not alter business plans for investment or spending according to a recent Federal Reserve study. The paper noted that the sensitivity of investment to changes in interest rates might be weaker than previously assumed. Survey results showed even a large (300 basis points) decline in interest rates would leave 68% of firms with unchanged investment plans. If zero interest rates have not generated the inflation central banks are looking for, rates below 0% may not either. As global central banks search for more remedies to address a low-rate, sub-par GDP growth environment, Japan remains a cautionary tale as years of extraordinary monetary measures have failed to lift demand and growth.

U.S. Economy

Without the U.S. consumer, a slow-motion U.S. and global economy would likely be in recession. GDP tracking estimates indicate the economy may struggle to match even the disappointing 1.4% annualized fourth quarter gain. Trade and inventory drag, plus soggy investment, weigh against moderate consumer spending growth and halting improvement in housing activity. The Federal Reserve acknowledged it was probably too optimistic in its earlier expectation of a faster pace of rate increases and reduced its December expectation of four hikes in 2016, to just two, assuming all goes well. As of the end of March, market-implied odds stood at just 54% for even one more hike in 2016. The message is that markets still think the Fed is over-promising, compared to the array of downside risks still facing the global economy. The Federal Reserve in December projected 2016 GDP growth of 2.4% and in March lowered the forecast to 2.2% growth. We see overall 2016 U.S. growth stuck in a range of 1.5% to 2.0%.

Employment and Wages

Employment has benefited from the government's easy monetary policy. Nonfarm payrolls rose 215,000 in March, topping off a first quarter average of 209,000. Manufacturing jobs fell 29,000 with a drop of 18,000 in February. The service sector continues to provide the bulk of net hiring, led by health care at 44,000, retail trade at 48,000, and leisure and hospitality at 40,000. The share of manufacturing employment has fallen to 8.6% of total U.S. payrolls, from 10.1% in 2007, 13.1% in 2000, and over 20% in 1980. Reflecting the overall shift toward services, education and health care jobs have steadily risen from below 8% in 1990, to 15.7% in 2016, while leisure and hospitality jobs comprise 10.7% currently, rising from 7.4% over the past 35 years. In general, service jobs do not pay as well and the data shows average incomes stagnant over the past decade.

Real Estate

Limited supply continues to pressure home prices and rents, eating up a portion of the savings households were supposed to reap from lower gasoline prices. The broad 20-city Case-Shiller home price index rose 5.8% y/y in January, accelerating from prevailing 2015 levels, while the supply of existing homes fell to 4.1 months in the three months through February. That is the lowest on record save for a few months in early 2005, when home prices were rising over 15% y/y. Rental vacancy rates are the lowest in over 20 years, at 7% in the fourth quarter according to Census Bureau data, down from 8.2% at year-end 2013, and 9.6% on average from 2000 to 2010.

Consumer and Manufacturing

Sentiment remains firm, as the University of Michigan consumer sentiment survey ticked higher in the first quarter averaging 91.6 vs. 91.3 the prior quarter. Retail sales excluding autos and gas decelerated to 0.1% m/m on average in January and February. Light vehicle sales disappointed expectations in March, falling to 16.5 million annualized. The full quarter recorded 17.1M, after 17.8M in the fourth quarter. This is one reason real consumer spending will likely moderate to 2% or below. On the household debt front, New York Fed data through the fourth quarter showed a $51 billion increase in debt, lead by a $19 billion increase in both auto and credit card balances and a $29 billion increase in student loan debt. Mortgage debt fell $11 billion. Student loans now total $1.2 trillion and student loan debt has increased 12% annually since 2005.

The ISM Manufacturing Index rose above 50 in March for the first time since last August. A bottoming in commodity prices spurred new orders up 6.8 points in the month, but firms remained reluctant to hire. The underlying sub-index breakdown still suggested weak employment growth (sub-50 for four months), matching soft jobs report data. A total decline in industrial output of 1.6% over the twelve months through February can be broken down into a 1.1% gain in manufacturing, a 9.9% decline in utilities, and a 10.7% drop in mining activity. Weak manufacturing numbers do not bode well for the economy or the Fed's ability to raise rates.

World Economy

Europe

Bowing to weaker inflation pressures, the European Central Bank (ECB) not only cut rates again in March, but also boosted its bond purchase program extending the program to include corporate bonds and increased liquidity provision via an extension of longer-term bank financing. The bond purchase program was boosted by a third to €80 billion per month, while the deposit rate was cut 10 bps to a new low of -0.4%. Business survey results continue to show the clearest strength in services with the Purchasing Manager's Index (PMI) at 53.1 in March, down from Q4 54.2, as soft prices drove spending higher. Manufacturing PMI remains weaker, but still above 50 on average. GDP growth was steady at 1.6% y/y in the fourth quarter, matching the prior two quarters. The UK referendum on EU membership will create event risk in mid-June, though even a vote to exit would only be the start of a lengthy process.

Japan

Despite a 30% decline in the yen since its 2012 highs (even after a 7.8% rise in the first quarter), inflation continues to hover around 0%, and real GDP growth has averaged 0.3% y/y in 2014-15. Sentiment among large manufacturers weakened to its lowest level since mid-2013. The BOJ introduced negative interest rates in January, which helped drive even 10-year government yields below zero, from 0.2% prior to the surprise announcement (0.5% in mid-2015), to as low as -0.1% in late-March. Investors reacted by selling off bank stocks, which fell over 25% over the following two weeks. Expectations call for more action as soon as April. The central bank may have to purchase a wider array of assets and push deposit rates further below zero. Outright debt monetization may follow; the central bank will never sell government bonds it has bought, while the government never has to repay the obligations.

China and Developing World

The People's Bank of China (PBOC) eased policy further in March, reducing bank reserve requirements for a fifth time over the past year. Rising debt concerns are not receding as the domestic real estate market surged in the first quarter. Average sales prices in Beijing rose an astounding 32% y/y in February, Shenzhen 74%, and Shanghai 24%. This follows peak-to-trough equity market decline of 49% from June 2015 through January 2016, suggesting that one speculative market has been traded for another. Authorities reduced down payment requirements in 2015 to spur what at the time was sluggish performance. Private-sector manufacturing and services PMIs did bounce in March (the former to 49.7 from 48.0, the latter to 52.2 from 51.2). Brazil's political turmoil deepened as impeachment speculation dogged President Rousseff. Brazil's GDP fell 5.9% y/y in the fourth quarter, or 5.7% annualized on a quarterly basis. The International Monetary Fund (IMF) in April cut its world growth forecast for 2016 from 3.4% to 3.2% after disappointing world growth of 2.4% in 2015. Our world GDP forecast is 2.5% supported by increased growth in the eurozone, but offset by struggling emerging market growth and an increased risk of currency devaluations.

Investment Perspective

The recent volatility in the markets - the S&P 500 was down 10% at one point in the first quarter - traces its roots back to 2014 when Saudi Arabia let oil prices fall and the Fed signaled that interest rates would start to rise in the coming year. With European and Japanese central banks continuing to ease to offset weak growth, the dollar strengthened. The stronger dollar along with weaker commodity prices squeezed emerging markets with commodity based economies and dollar denominated debt. This contributed to slower growth and more easing – and in an effort to boost their economies, negative interest rates. The dollar peaked as stocks bottomed out in February. Stable oil prices helped, but the most important factor for a slightly weaker dollar was the Fed's decision to dial back rate increases for the year. The concern is slow global growth in developed markets with aging populations, lower productivity, and low inflation.

Historically, stock prices and earnings move in tandem. Prices this year have been driven less by current earnings than investors' willingness to place a higher value on future (hoped for) earnings and the prospect for continued low interest rates. First quarter earnings are forecast to slump -8.5% y/y and have declined for four quarters, the longest streak since the financial crisis. Earnings have been hampered by the strong dollar, falling energy prices, and weak consumer spending. Even though shares are still more expensive than their historical averages and the decline in earnings further stretches valuations, the hope is that low rates lead to a strong rebound in the economy with higher earnings in the future.

So stocks seem to be somewhat overvalued and roll around like a marble on a table top, but bonds are even more over-valued even as some countries' bonds trade at negative rates. Who will invest in bonds with negative rates and guaranteed losses? Equity valuations still remain stretched and are more difficult to assess in a world with 0% or negative interest rates. Financial companies and banks are finding it increasingly difficult to make money in an industry with more regulation and 0% interest rates. Insurance companies and pension plans with long-term liabilities - future promises to policy holders and pensioners - that depend on 7 or 8% future returns in their own investments face the risk of not meeting their obligations. Precious metals have recently benefited from the extension of global monetary easing and its negative effect on paper currencies. After cratering in February, oil prices rose even in face of ample supply as the dollar weakened and global demand increased. Oil rig counts in North America are down over 50% y/y in April, falling from 1,087 rigs to 484. We remain invested in healthcare, consumer stocks, some technology, telecom, utilities, and industrials. Companies with solid financials, strong management, and growth prospects at reasonable valuations remain our focus. Though risk and volatility are high, our present composition seems the only logical one to avoid the timing risk of moving in and out of markets and to preserve the purchasing power of assets over time. Even though negative rates have turned the financial world upside down, investing is the only sound alternative in real terms. We remain vigilant and persevering.

March 31, 2016
DJIA: 17,685.09
S&P 500: 2,059.74

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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