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It's Time to Carry an Umbrella at All Times

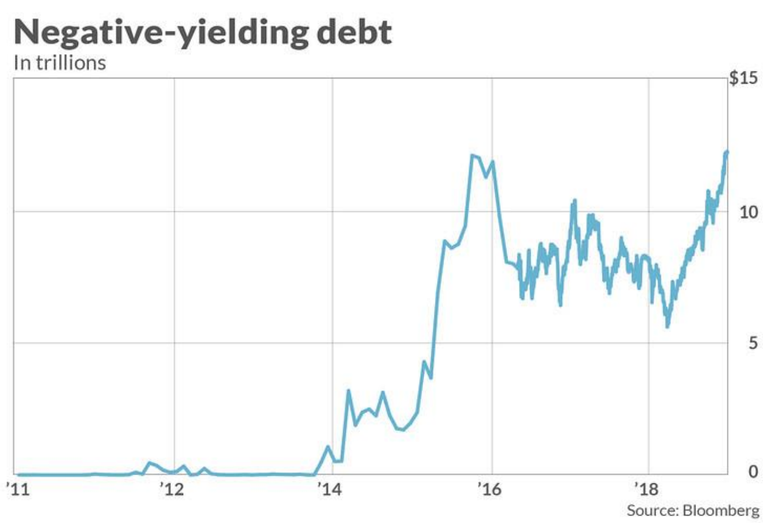
"Bankers Stunned as Negative Rates Sweep Across Danish Mortgages"
Bloomberg Headline, May 23, 2019

Yes, this sensationalistic headline is true. One can indeed get a mortgage in Denmark where the interest rate is negative, meaning the borrower gets a check from the banker every month as a thank you payment for taking the mortgage.[1]

How can this be? Why would lenders pay borrowers, instead of charging them interest? This upside-down world is the one that the Mock Turtle in *Alice in Wonderland* would describe as "Well, I never heard it before but it sounds uncommon nonsense".

Below, we provide a brief background on negative interest rates, and then address this question: "Should you change your investment game plan in light of this unusual situation? If yes, how?"

Negative interest rates became a major phenomenon in 2014 when the European Central Bank (ECB) decided to pay commercial banks a negative rate on the deposits they held at the ECB. Then, the Bank of Japan (BOJ) followed suit. Their actions led to negative interest rates on government bonds in Europe and Japan. The graph below from a recent MarketWatch news item shows that negative yielding bonds have gone from zero to over $12 trillion.



[1] The Bloomberg article does clarify that negative interest rates are available only on adjustable rate mortgages shorter than five years and the borrower does have to pay some upfront fees.

Central banks are coercing savers to spend their money or invest it in something that is riskier than bank deposits and money market funds. Central bankers are obsessed with generating economic growth. Their concern is that the current anemic growth might lead to deflation, and that deflation will create a downward spiral of more negative growth and more deflation. This mortal fear of deflation, influenced by the depression era experience of the 1930s, drives the central banks' current experiment with negative interest rates. By forcing savers to spend and invest, the bankers' hope that they can generate economic growth and stave off the dreaded deflationary spiral.

Have the central banks succeeded in their efforts?

Growth in Europe and Japan has actually been anemic and that makes the central bankers' tactics questionable. The bankers, in their defense, argue that growth would have been awful, not just anemic, and that we might have fallen into the deflationary spiral, if they had not taken such extreme actions. It is hard to get to a consensus on the impact of central bankers' actions on economic growth, but it is easier to reach consensus on the conclusion that central bankers' actions have propped up prices of stocks, bonds, real estate and other risky assets over the last few years.

The United States Federal Reserve Bank ("the Fed") matched the ECB and BOJ's actions for many years following the financial crisis in 2008. Then, strong growth in the U.S. allowed the Fed to diverge and raise short-term interest rates until the beginning of this year. In recent months, the Fed has signaled that it will once again start cutting interest rates because of concerns regarding weak economic growth.

In light of central bankers' aggressive activism to drive interest rates so low, it is natural for investors to ask the following questions.

- Will the central banks continue to cut interest rates? If they do, how far can they go?
- Are there any negative consequences to central bankers' recent actions?
- Should investors change how they invest their money in light of these unprecedented actions by the central banks.

Below, we address each of these questions.

Will Central Banks Cut Interest Rates Further? How Far Can They Go?
Yes, they are likely to cut interest rates further. Recent statements by central bankers Jerome Powell, Mario Draghi and Christine Lagarde clearly indicate as such. They will keep going until one of the following two things happens.

- Either, economic growth becomes strong and inflation is consistently above the 2% target,
- Or, something breaks in the financial system that sends a clear message that the market will not tolerate highly negative interest rates?

Are There Negative Consequences to the Central Banks' Recent Actions?
Some of the negative consequences are well-documented and they include market distortions, artificial incentives to take risks, penalty on savers, higher wealth inequality and an increase in liabilities for pension funds. In some cases, those suffering the negative consequences have also

received corresponding benefits in the form of higher asset prices and lower interest costs. Somewhat surprisingly, the one negative consequence that many experts feared the most, namely, runaway inflation, has not materialized, at least not so far.

Should Investors Change How They Invest Their Money?
Yes, we at High Pointe believe that it behooves investors to proactively think about the central bankers' actions and their likely future path, and make some changes in how they have traditionally managed their portfolios. Below, we offer some specific suggestions and the rationale behind them.

Equities: In our opinion, underweighting both debtors and creditors makes sense, unless their valuations become more compelling. Our rationale is as follows. Many highly indebted companies have been able to survive because central bankers kept their interest costs low. A business that relies on the mercy of the central bank is not advisable to own. The rationale for underweighting creditors (banks) is twofold. One, low interest rates reduce their profitability. Secondly, and more importantly, banks employ substantial leverage in their business and they will be the first line of defense if there is a hiccup in the financial system. By contrast, overweighting companies with stable business that generate significant free cash flow and have moderate levels of debt makes sense, so long as their valuations are reasonable.

Fixed Income: Instead of choosing the conventional path of investing in intermediate duration, investment-grade corporate and mortgage-backed bonds, it makes sense to designate a portion of the fixed income assets to insure against deflation by investing in Treasury bonds. The capital preservation portion of the portfolio should be investment in Treasury-only, rather than broadly diversified, money market funds. Investors concerned about the possibility of runaway inflation can also consider investing in Treasury Inflation-Protected Securities.

Real Assets: It also makes sense to gain some exposure to real (physical) assets and companies that own real assets. Examples of real assets include real estate, commodities, and precious metals. These assets provide diversification benefits and some of them, like gold have potential safe-haven properties. Over the last few decades, gold has been shunned from modern portfolios because it did not produce any income and, therefore, the opportunity cost of holding gold was significant. In the current era of low and negative interest rates, that opportunity cost is less of a factor thus allowing the diversification benefit of gold to be a dominant factor in decision making.

One more question.

Could it be that Worrying about Central Bankers' Action Turns Out to be Unnecessary?
Yes, that is indeed possible. It is conceivable that central banks successfully engineer growth, generate moderate inflation but not too much inflation, and go back to following a narrow, safety-oriented mandate rather than the recent activist, growth-at-all-costs, mandate. However, evidence from recent years makes it hard to believe that they can achieve such *nirvana*. Thus, it makes sense to be prepared in case they don't succeed. Fortunately, the cost of preparation for this disruptive scenario is minimal. Our portfolio strategy suggestions do not require investors to become ultra conservative and rush to cash, or take other drastic actions that would incur significant real or opportunity costs. In fact, some of the investments that provide defensiveness,

e.g. equities of companies engaged in real assets such as gold mining, are undervalued, in our opinion, thus making it easy to benefit from their low beta without paying a lot for them.

In Summary

When investors survey the investment landscape, it is possible that their outlook would be sanguine because of the stock market's recent strong returns and a fairly strong economy as measured by low unemployment. In other words, if they stick their heads out the window, it might look like a clear day. Nevertheless, we suggest carrying an umbrella. This umbrella does not cost much at this time and it will come in handy if it rains. If they wait to buy the umbrella when it starts raining, it might be too late to get one. We are already managing our clients' portfolios with this mindset.

Gautam Dhingra and Chris Olson
July 18, 2019