TREASURY | PARTNERS

Immediate Gratification

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In an effort to reignite world economic growth, global central banks have introduced unorthodox policies that have distorted market prices. The following discussion highlights the risks investors face.

The Purpose of Interest

As you know, having money is a benefit – a unique one that allows its owner to obtain resources needed to achieve a goal. Just like any other resource, gaining access to others' cash and the immediate gratification it brings also has a price, commonly known as an interest rate. This is apparent throughout our economy: car purchases are financed with auto loans, home purchases are funded with mortgages, etc. We have long understood that immediate gratification comes with this cost (interest expense), and organize our societies accordingly. The lenders of capital – banks, finance companies, etc. – are paid interest by the borrowers of capital. That's how it's always been.

Our financial institutions and markets rely on this simple lender-borrower relationship. Lenders require interest income in order to benefit from the arrangement. Banks help connect lenders and borrowers. Pension plans pool participant resources and make loans to fulfill retirement promises. Insurance companies sell "peace of mind" through insurance policies in exchange for premiums, which are invested in interest-bearing assets to secure these promises. Retired 'Baby Boomers' invest a large portion of their life savings in income-producing bonds during retirement.

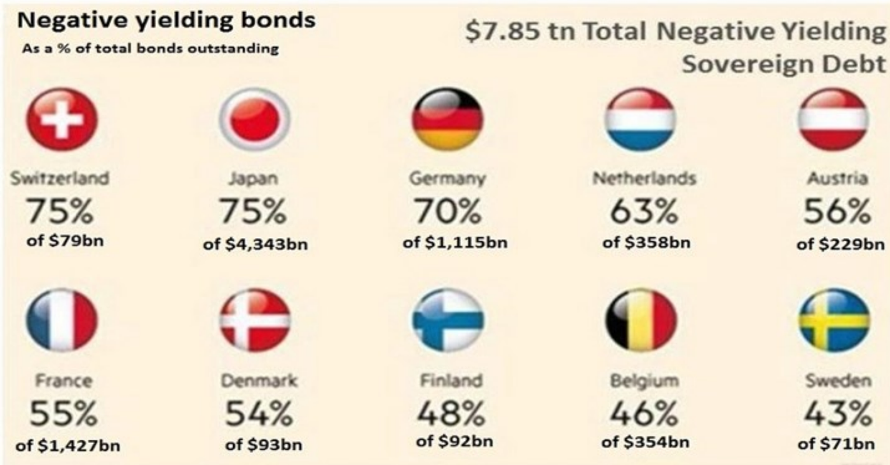
But today, the core idea underlying these institutions has been shattered by global central bank monetary policies. Since the 2008 financial crisis, global central banks have slashed rates to zero and even negative in an all-out effort to encourage immediate gratification.

The belief is that ever-lower rates will 'pull forward' economic activity to jump-start growth. But it simply hasn't worked effectively , and despite years of these extreme measures, economic growth in Europe, Britain and Japan remains weak.

Markets Distorted

We believe the consequences of these experimental policies have resulted in massive, largely unprecedented market distortions across a number of major asset classes. For example:

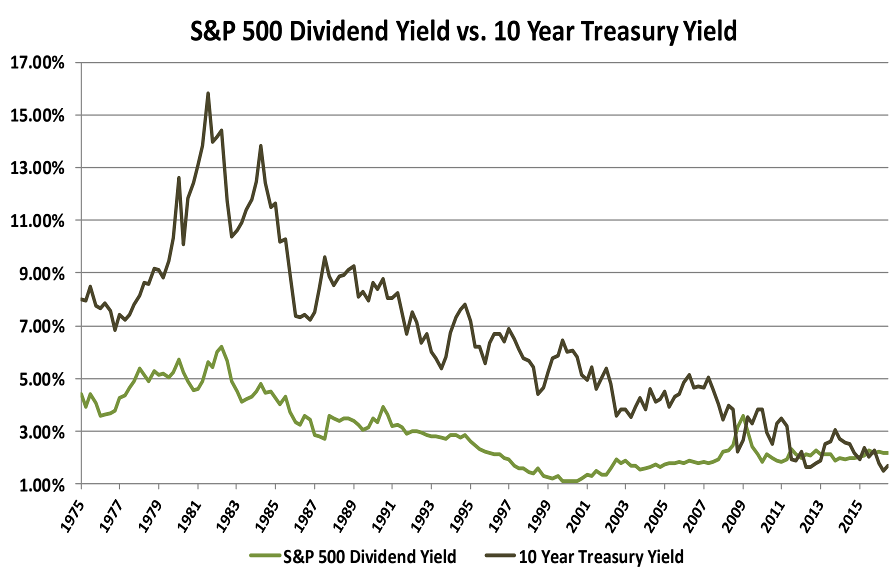
- In Europe and Japan, negative rates on sovereign debt have become so common that they are prevalent in half or more of many countries' outstanding bonds.



Source: DoubleLine Funds (data as of 4/30/16)

- The extremes in European and Japanese Sovereign rates have spread to corporate bonds, where French pharmaceutical firm Sanofi and Japanese automaker Toyota recently issued bonds at negative rates. Meanwhile, certain *junk-rated* European corporate bonds now trade at levels close to 0%.

- Although negative rates haven't yet hit American shores, the prolonged period of near-zero US rates has caused yield-hungry investors to crowd into other income-bearing assets. More prominently, the S&P 500 dividend yield currently exceeds the yield on 10 year Treasuries – a rare anomaly in modern times.



Source: Bloomberg

In-Depth: Recapping Post-Crisis Central Bank Actions

In the immediate aftermath of the 2008 crisis, each of the "Big Four" global central banks – the US Federal Reserve ("Fed"), the Bank of Japan ("BOJ"), the European Central Bank ("ECB"), and the Bank of England ("BOE") - raced to reduce their benchmark interest rates. In short order, each reached or came close to 0%, a very rare event in economic history.

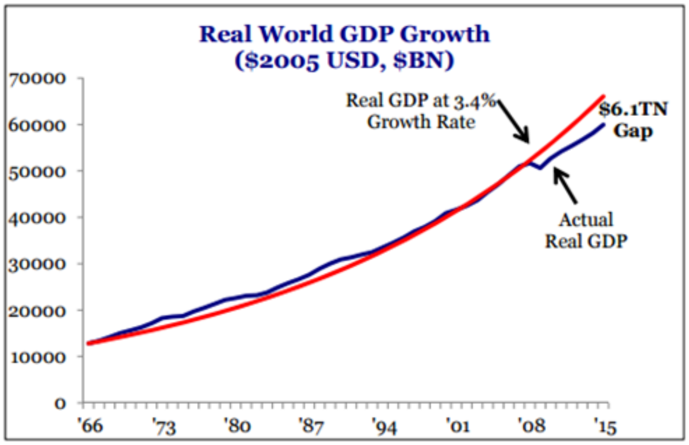
Soon, each central bank judged their "ZIRP" (Zero Interest Rate Policy) initiatives alone would not encourage sufficient borrowing and economic activity, and also launched Quantitative Easing ("QE") programs. QE involves directly purchasing substantial percentages of their respective nations' sovereign debt (and sometimes even corporate bonds and equities) to further drive down interest rates, pushing investors into other, riskier asset classes in a hunt for higher yields.

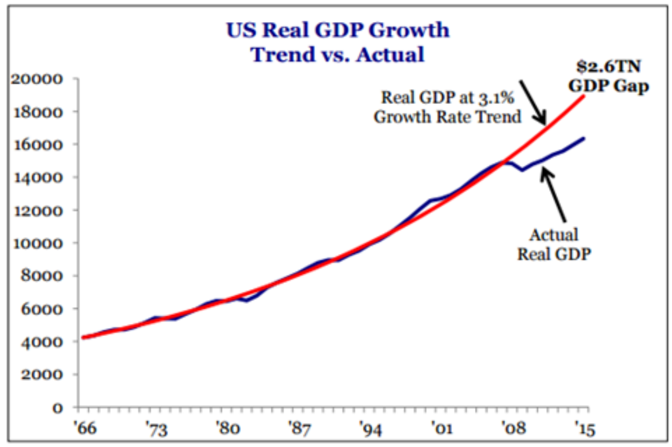
More recently, the ECB and BOJ have resorted to additional easing by "breaking the zero bound" via "NIRP" (Negative Interest Rate Policy), which sets the benchmark rates at negative levels. The effect has been to drive yields on longer-dated bonds into negative territory. This effectively locks in a guaranteed loss for investors who purchase negative-yielding bonds to maturity.

Uninspiring Results

Despite these troubling distortions, we see tepid fundamental economic improvement. Some of our most prominent concerns are:

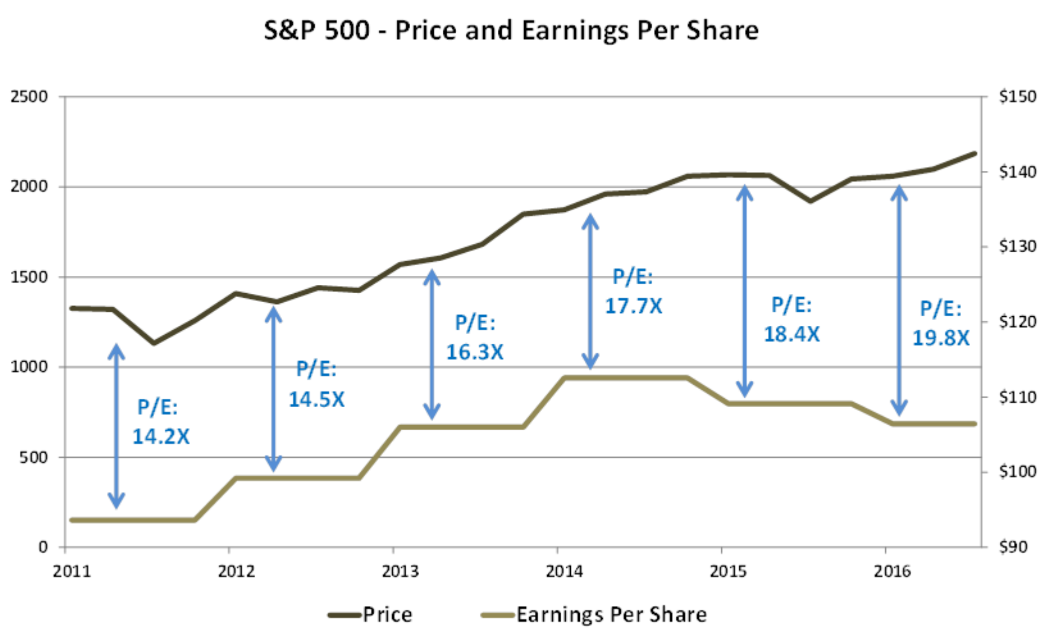
- **GDP growth remains muted.** An enduring wound of the 2008 financial crisis is the sluggish growth experienced by the US and world economies. For over 50 years, global and US (real) GDP growth averaged 3.4% and 3.0% per year, respectively. Since 2008, it has averaged only 2.1% and 2.0% - basically, economic growth is running fully *one third less than expected*. After 8 years of unconventional monetary policy, this "growth gap," hasn't been eliminated, costing the US \$2.5 trillion and the world \$6 trillion in lost GDP *in just the last year*. To put these numbers into context, 2015 US GDP totaled \$17.9 trillion.





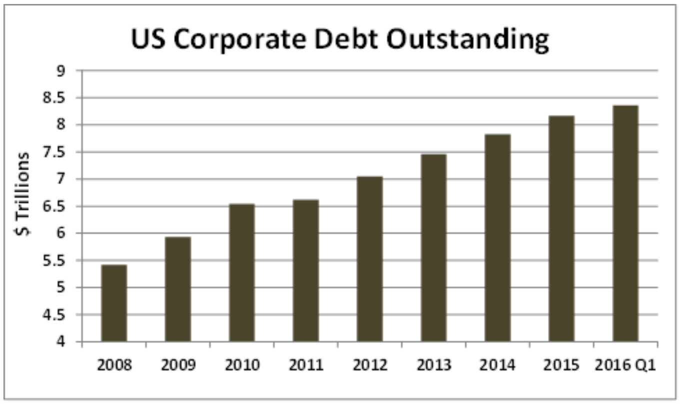
Source: Strategas

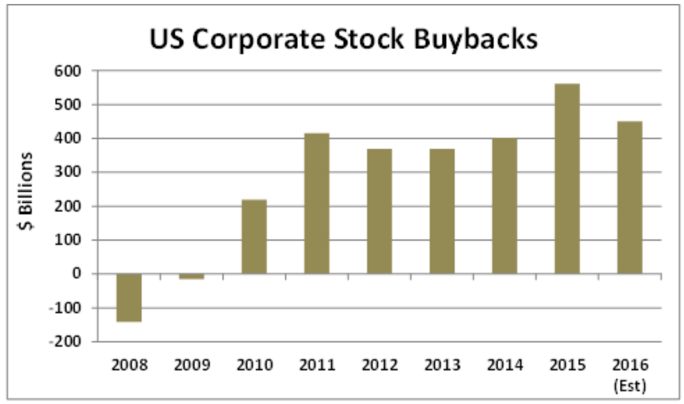
- **Disappointing corporate earnings.** Although the S&P 500 remains near all-time highs, its run-up in price is due to multiple expansion instead of earnings growth – i.e, the numerator of the price/earnings ratio is driving the increase. Its current P/E of nearly 20X is now well above the long-term historic average of 16X, based on current 12 month trailing earnings. Furthermore, aggregate corporate profits, an indicator of the health and sustainability of the underlying businesses, have actually declined, falling from \$216B in Q2 2014 to \$192B in Q2 2016. This means equities are becoming more expensive as companies are becoming less profitable.



Source: Bloomberg

- **Underwhelming capital expenditures.** Companies have enthusiastically taken advantage of cheap rates, as evidenced by US corporate debt outstanding increasing by a hefty 60% since 2007. Troublingly, this windfall for corporate borrowers hasn't been used for new capital expenditures – investments in productive, revenue-generating assets and projects. Rather, borrowed funds have instead financed dividends and share buybacks, which merely boost stock prices without improving total company values and setting the stage for future growth. In fact, buybacks have been the dominant source of demand for domestic equities for several years.

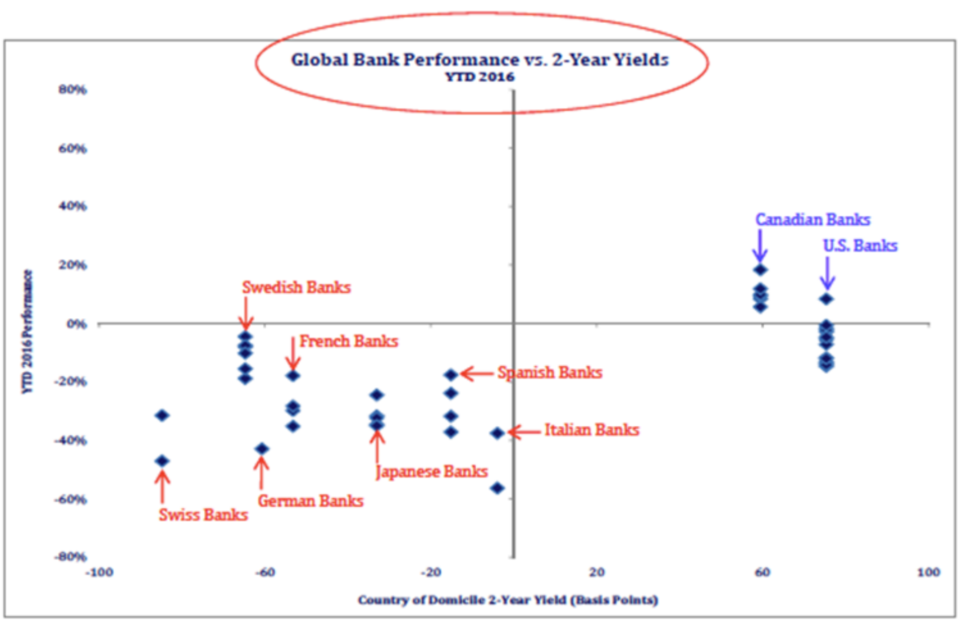




Sources: SIFMA and Goldman Sachs

- **"Unanticipated" reactions to negative rates.** While meant to stimulate consumption, lending and consumer confidence, reactions to ZIRP/NIRP have not necessarily gone according to plan. In fact, they may actually inspire *less* economic activity and confidence, as financial institutions and savers attempt to minimize the erosion of their capital in this unconventional environment.

  In Japan and Germany, sales of personal safes spiked after the implementation of NIRP - think cash hoarding. Commerzbank, one of Europe's largest retail banks, is considering hoarding cash in safes should European rates go further negative. Of course, hoarding more cash in safes means it won't be loaned out, which has a double-whammy effect: the money is unavailable to finance new economic activity, and the bank doesn't earn any interest profits that can offset its costs of doing business. However, since these same European banks find themselves sometimes *paying homeowners interest* on their floating rate mortgages, the prospect of lending isn't very attractive either. Traditional retail banks under NIRP are truly stuck between a rock and a hard place, and markets realize this – bank stocks within NIRP countries are underperforming bank stocks in non-NIRP countries.



Source: Strategas

The impact on individual savers – and particularly those in retirement – is just as harmful. A retiree who expected to earn 5% annual interest income on bonds but can now only hope for 2% is faced with a difficult choice: either cut back on lifestyle and spending, or assume more investment risk to make up the difference in returns. With the aging of the developed world's population and the surge of Baby Boomer retirees, this is a growing problem.

Taken as a whole, the outcome of these unprecedented central bank interventions is unimpressive. Despite central bankers effectively "pulling out all the stops" to pull forward economic activity by encouraging immediate gratification, real economic growth has been underwhelming. At the same time, asset prices have been inflated and we face the potential consequences of unwinding of market distortions.

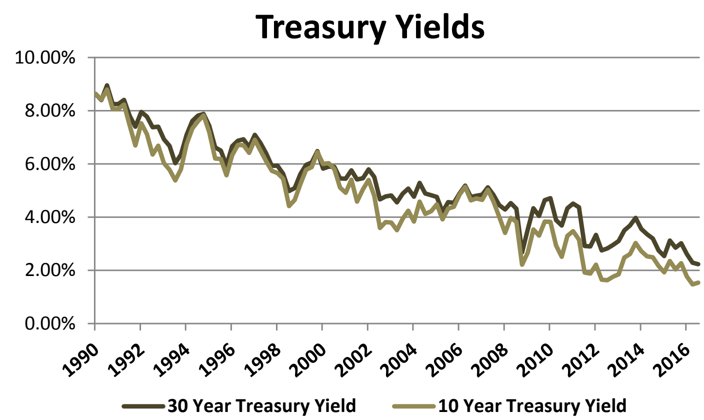
Conclusion

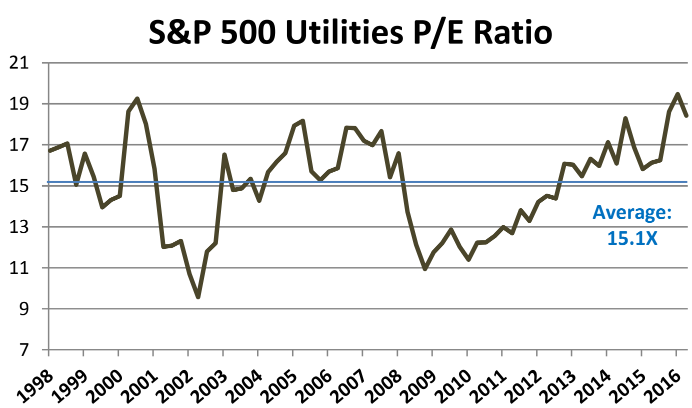
We reiterate our cautious outlook for both bonds and stocks. At this point, the long-term consequences of these unconventional central bank policies could ultimately result in more harm than good. The longer these rate-suppressing policies remain in place:

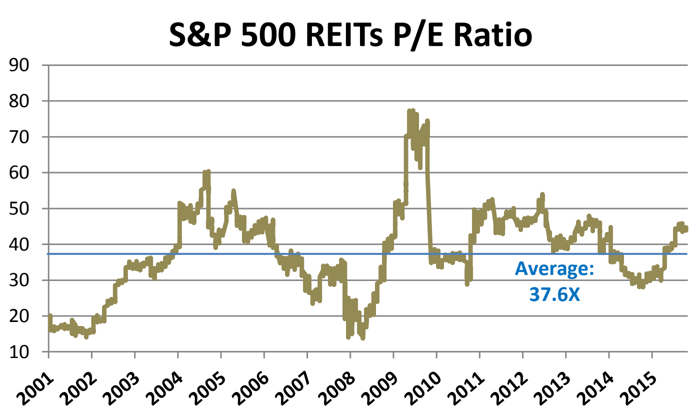
- Defined-benefit pension plans and insurance companies will fail to earn the returns necessary to meet their promises
- Banks may become more stingy with their lending and suffer from reduced earnings
- Retirees and savers will struggle to accumulate necessary assets for retirement

The overall effect has been to force yield-hungry investors to assume more risk, driving up the prices of yield-oriented securities to the point where, in many cases, their return potential doesn't offset the risks. These expensive asset classes stretch far and wide, visible in the low yields for longer-maturity US Treasury and Investment Grade Corporate Bonds, Municipal Bonds, and High Yield Debt, and the elevated price/earnings ratios for yield-generating Common Stocks, such as "bond substitutes" in the Utility and REIT sectors.

Accordingly, we have positioned client portfolios in a more defensive manner as we monitor market developments. This means we're maintaining higher allocations to shorter maturity liquid corporate bonds and lower allocations to equities and other risk assets in an effort to raise downside protection in this unprecedented environment. As always, we are available to discuss the structure and details of your specific portfolio in greater detail.







Source: Bloomberg

Disclosure