3rd Quarter 2016 Outlook

Federal Reserve Strategy and Tactics

Our report this quarter deals primarily with Central Banks in general, and the U.S. Federal Reserve Bank in particular. We will also comment on a new instrument which the world of finance has rolled out called negative interest rates. Central Bankers hope negative rates will lend stability for further growth, not only here but around the world.

So in this report, we will examine negative interest rates, and some of the rationale behind them, comment on where this may lead, what its ramification might be; and how then we might adjust to and profit from it.

Background

We have often opined on the impact that Federal Reserve policy has on the financial markets. Perhaps the most significant of these policies, is that the central bank has kept its benchmark rate near zero now for over six years. This policy, however, has largely met its objectives; that of stabilizing the economy and the banking system after the huge hit to both the debt and equity markets in the aftermath of the 2007-2008 financial debacle. Because their strategy of ultra-low rates has brought more liquidity to the market, a number of economists and Wall Street analysts are questioning whether or not its time to begin raising rates. Indeed, while these ideas are being increasingly discussed on Wall Street, the Fed itself is beginning to move in that direction. The Fed's policy statement for the last several months have ended up by maintaining low interest rates, even after approving a ¼% hike in December. That was the last Fed rate hike, and it was approved on a 7-3 vote. The three dissents underscored the deep divisions inside the Fed as it trys to begin its transition from an extended period of ultra-low rates to a period in which it will start to raise rates.[1]

These discussions have led to a return of heightened volatility as it relates to currency markets. For months a number of large investors, including hedge funds, have bet that the dollar will rise against the euro, Japanese yen and many emerging-market currencies. In March, and again in May, the Federal Reserve's policy statement once again made clear that Fed officials aren't in agreement on further short-term interest-rate increases, and the widely annonced future increase scheduled for June did not happen. Our view is that it probably won't happen in the immediate future either.

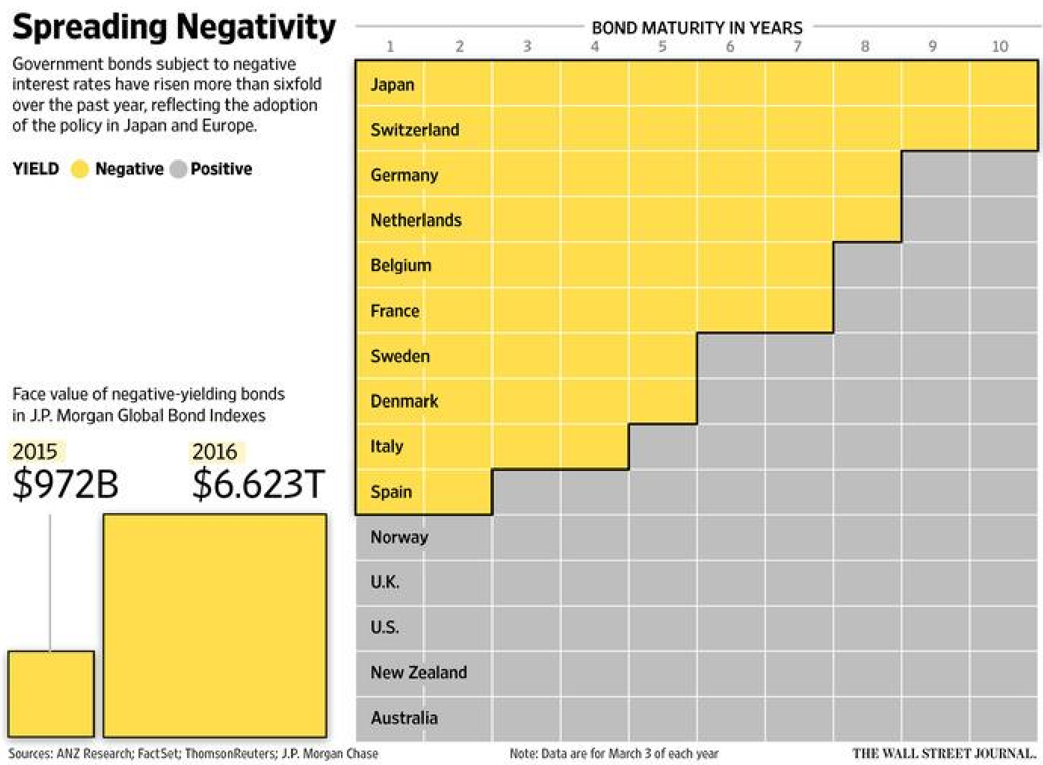
Negative Interest Rates

Perhaps the most visible sign that interest rates will stay low for the time being, is that we are now observing the beginnings of negative interest rates around the world. This is something that, for all practical purposes, has never been done before. It did however, occur briefly, in 1939, near the end of The Depression; wherin Chrysler had to pay Chase Bank to hold their working capital funds. That's the only past incident of negative rates that we are aware of. What's happening now, though, is historic. As you can see from Chart 1 below, no fewer that 10 countries now have negative interest rates in effect.

[1] Los Angeles Times ï January 8, 2015

A. So what are negative interest rates? Negative interest rates are financial instruments which are intended to stabilize and strengthen the world's banking system.

B. We define negative interest rates as just that. In other words, the borrower, instead of paying interest to a bank or a creditor for a loan, actually receives interest back. Believe it or not, this has taken place in parts of Europe and Japan, and the retail aspect of this market won't last, for obvious reasons. As it pertains to banks, however, large corporations, government agencies and wealthy individuals need a place to store their money. If the banking system is having difficulty re-lending that money, they will charge you for the privilege of holding your cash balances. This is historic.



The Wall Street Journal – March 10, 2016

According to The Wall Street Journal the face value of negative yielding bonds grew from just under $1 trillion in 2015 to over $6.6 trillion today. What is this all about, and what does it portend for the future?

Inflationary Aspects

To answer these questions, let's review the past. For many years, the Federal Reserve Bank policies as to monetary policy, was to use its money creating power in a way that would keep interest rates at a level whereby there would be little or no inflation in our system.

That may be counter-intuitive for many, as the mere act of creating money can be inflationary in of itself. If the creation of new money exceeds the supply of newly formed goods and services, inflation will result. However, in the past when the economy was let loose to grow as much and as fast as it could; if the output of goods and services created such an environment wherein prices of goods and service grew at an inflationary rate, then the Fed would come in and try to slow it down.

Historically, then, when inflation was rising, the Fed would tighten money (i.e. raise interest rates, or cut the supply of money) in order to drive down demand for goods and services, or to drive down demand to the point whereby price levels would stabilize.

Inflation was a dirty word. Alan Greenspan, Fed chairman for many years, constantly repeated that interest rates must rise to curtail inflation, whenever price levels started to rise. Indeed, as many of our readers may recall, the Fed viewed itself as the entity "To Take Away The Punch Bowl" when the party started getting out of hand.

This was the policy of the Federal Reserve for many decades. So now, what are the Central Banks around much of the world doing when they lower rates to the point that the borrowers pay the lender for holding their money?

Justification for Negative Rates

What is the justification for negative rates? We believe there are two major factors.

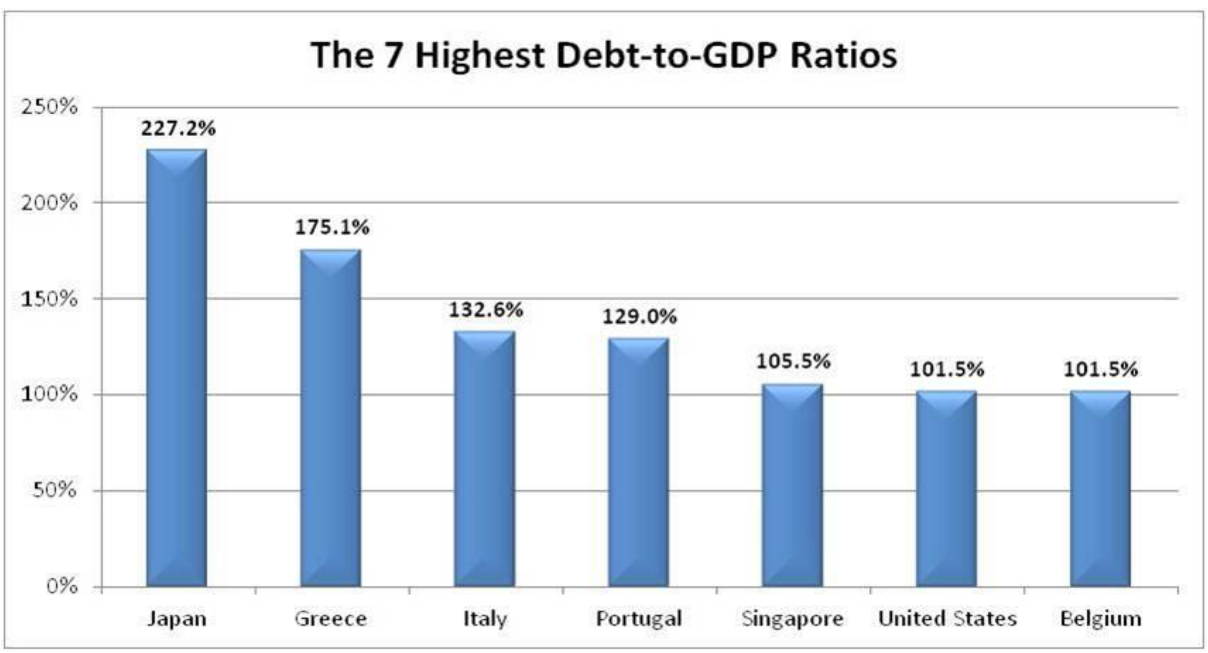
1) Sluggish growth. In the current environment the U.S. Gross Domestic Product grew just 0.5% in the January to March quarter, and preliminary estimates for growth in the second quarter are 0.8%[2]. The Eurozone was slightly stronger, but still grew at a weak 2.2%, which is better than they have doing recently. Japan, which has been in and out of recessions for the last 25 years, actually contracted at 1.1%. Thus, some of the pressure for negative interest rates is due to weak economic growth worldwide.

2) The second justification for negative rates is that governments around the world need low rates to finance massive government debts. Negative interest rates allow government borrowers to spend more, and it negates near term pain of higher interest payments to finance today's purchases. It's not just the U.S. that has accumulated large government debts, but countries all over the world. The total U.S. government debt, now at $19.3 trillion, is over 100% of Gross Domestic Product (GDP). Even relatively modest increases in interest would make interest payments a budget buster at the Federal level. Indeed, an interest rate of just 5%, would cost $965 billion dollars of interest annually, and would consume almost a third of the just over $3 trillion dollars in revenue the Federal government expects to

[2] The Bureau of Economic Analysis

collect this year (US Congressional Budget Office). So, there is tremendous pressure on the Federal Reserve and other central banks around the world to keep interest rates low so that interest costs do not get out of control. It seems that it is easier to lower interest rates than to control spending.

In fairness, it would appear that some percentage of the money put into negative interest accounts are commercial banks excess reserves parked at Central Banks. Two to three years ago, commerical banks could earn 5 to 25 basis points interest (.005% - .025%) for keeping excess reserves at the Fed (in the U.S.) and the European Central Bank in Europe. Now it's going the other way, inducing commerical banks to make loans with that money. For individual depositors, however, negative interest rates are an illusion as negative rates primarily pertain to government borrowers who have access to this market.



Source: Forbes

In our judgement, negative rates makes no sense, unless demand levels are so low, and the world economy so weak, that the Fed and other Central Banks feel that they need to continue to stimulate in order to avoid a recession. In other words, to put out more punch bowls rather than take one away.

Change of Philosophy at the Central Bank

Central Banks have an answer for these negative rates. Instead of fighting inflation as they have done for the past 50 years, they are now embracing it, as long as it stops at a low and tolerable level. Indeed, both the U.S. Federal Reserve Bank and the European Central Banks (ECB) are helping and encouraging inflation to rise from the zero level to 2%. This policy has been working to essentially create and sustain a zero interest rate policy worldwide. Why is that? The Wall Street Journal suggests that the answer for this phenomenum, is that negative rates encourage borrowing, and are intended to create demand for goods and services. In fact, this is occuring worldwide. So negative rates have increased borrowing in these countries where negative rates are prevelant.

In our view, this new policy of negative rates is a surrepticous way to take quantitative easing – i.e. the creation of money to a new level. We think this has some elements of risk we don't like, particularly if one looks at the rear view mirror and sees the level of debt compounding to all time highs. We believe the increasing level of debt is the real problem, and that there is a pressing need for Congress and our President to utilize fiscal policy to bring the debt level down, or to suppress its growth. If that were to occur, we believe negative rates would be unnecessary, and that real growth would then occur. It's not to late to implement this, and we think it should be a matter of concern to all.

We are not alone in our analysis. Let's take a closer look at all this. Bill Gross, former President of Pimco, the $1.5 trillion bond fund, and now President of Janus Global Bond Fund, was interviewed in Barron's recently as opining that credit (as reflected by the current volume of debt outstanding) has reached a saturation point, and that incremental economic gains due to incremental money creation is at a point where every incremental increase has less and less effect.

It would then follow from Gross' comments, and to the degree to which he is correct, that we (the U.S) and the rest of the world are entering a slow growth period, one where decent yields (of 4-7% as an example) are going to be much harder to find.

Once again, the way out of this, in our judgment, is a return to fiscal sanity, and move towards a balanced budget. This would give the Federal Reserve a reason to start raising rates – albeitly small, but enough to give savers an incentive to save, and in Gross' own words "savers are the bedrock of capitalism". Without a positive return to investors and savers, Americans will start buying mattresses to hold their money. With a positive return on CD's, Treasuries, and money market funds – banks and other fiduciaries will lend and/or invest funds with those savings, which in turn, will jump start the economy, and provide us with the funds necessary to grow our economy. Without a positive return on money, we fear a world economy of stagnation, and little growth.

In the meantime, as investors (and banks for that matter), adjust to this new rate structure, we believe it bodes well (on a relative basis) for income producing securities. If we are correct on this assumption, this would tend to support our thesis of investing in high quality securities that are returning cash to investors through dividends and stock repurchases, particularly in shares of those dividend paying stocks which are raising dividends each year.

Also, the lower interest rates go, the better income vehicles will be, both in longer duration fixed income and for REITs, preferred stocks, and convertible equities.

As always, we thank you for your continued support. Please call with any questions you might have.

Sincerely,

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