



TOM SEAY, SENIOR MANAGING DIRECTOR, RESEARCH

DECADES LATER, WE HAVE NEGATIVE RATES

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As we enter a new decade, reflection takes on a grander and more expansive meaning. I don't reflect on the five pounds I lost last year but cannot imagine that five decades ago I was seventy-five pounds lighter. Similarly, last year's interest rate decline¹ seems insignificant when compared to the decline from 15.84% almost four decades ago on September 30, 1981. We all should rejoice over last year's 31% gain in the S&P 500², but that is puny when compared to the 2,685% cumulative increase since September 30, 1981³. 2019 was a marvelous year for investors, but the last four decades have been stupendous. Although falling rates have helped investment returns, should the U.S. proceed to negative rates, the environment going forward will be challenging.

HOW DID WE GET HERE?

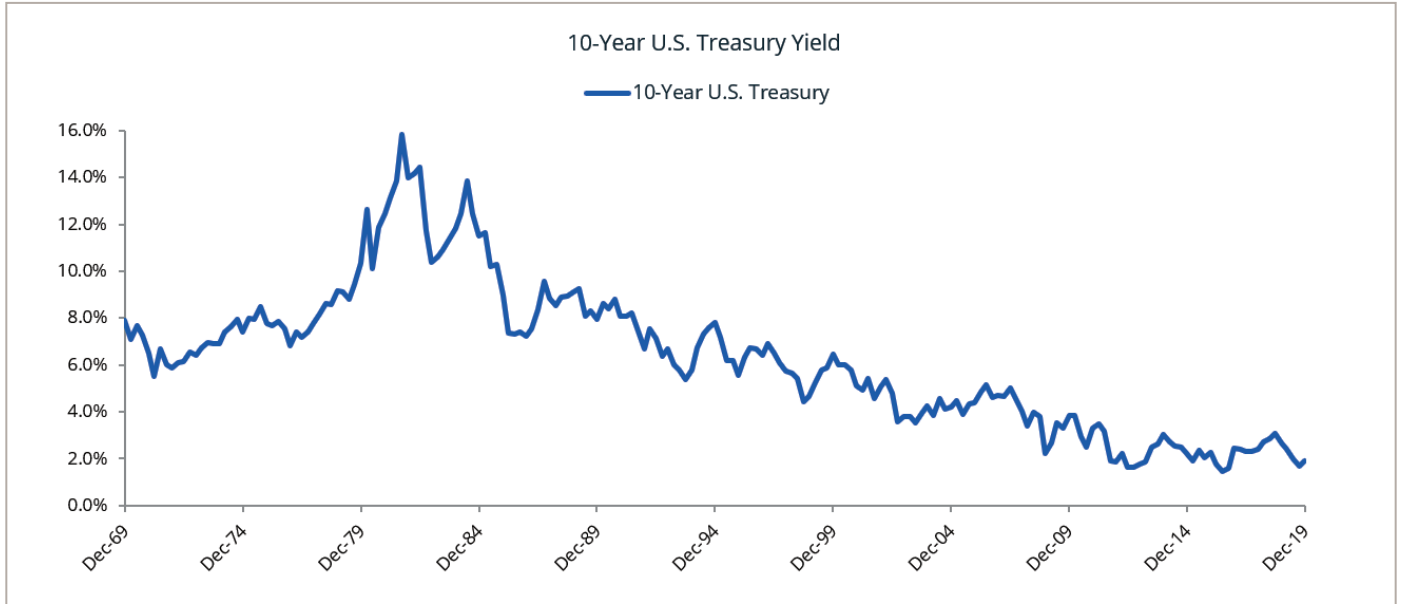
Reflecting over decades exposes major changes that may not have seemed momentous at the time but have had long-term and lasting effects. When I was a young man on Wall Street, Paul Volcker became Chairman of the Federal Reserve. His singular focus was on eliminating runaway inflation in the U.S. economy. Today, the monetary policies of the Volcker Federal Reserve Board are widely credited with curbing the rate of inflation, which peaked at 14.8% in March 1980³, but at the time it seemed to be business as usual.

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Fast forward 40 years, the Jerome Powell Fed has a 2% inflation goal and is struggling to reach that level. As the following chart illustrates, the decline in interest rates that began during the Volcker era continues to today. Proactive inflation-fighting monetary policy is now the norm and has given investors comfort that inflation will not be allowed to run wild, and the confidence to invest in the financial markets.

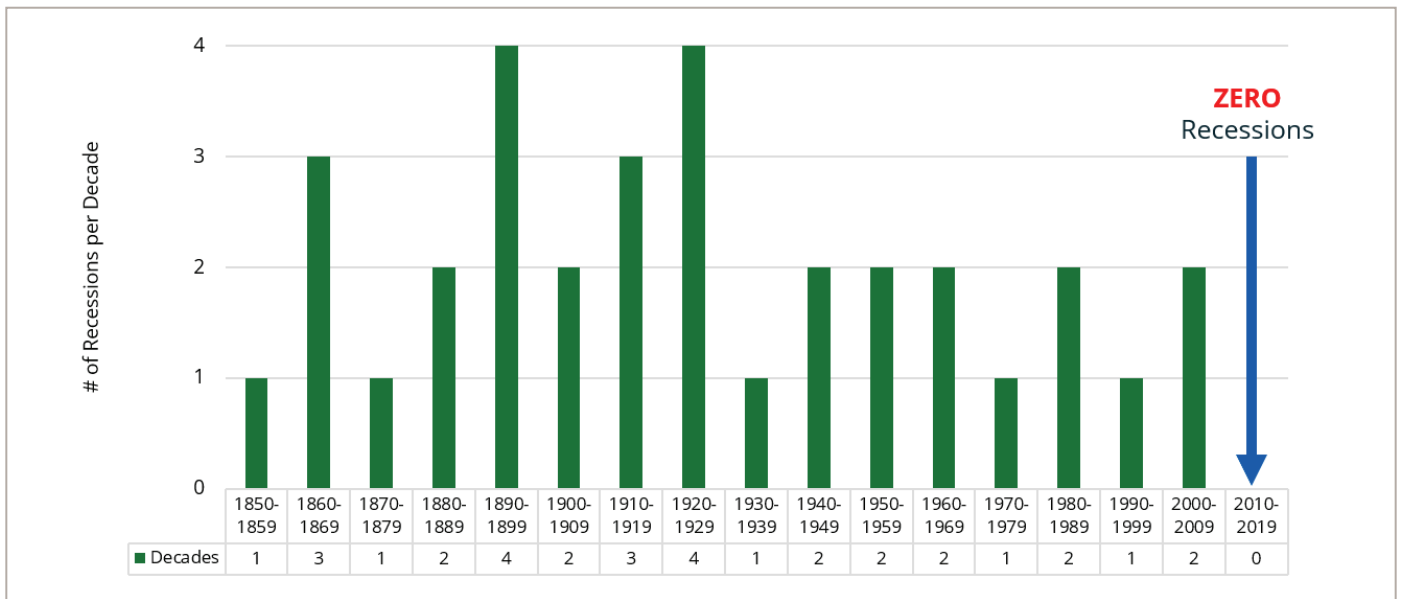
How Low Can They Go?



Sources: Clearstead, Bloomberg.

The benefits of a disciplined monetary policy and low interest rates are numerous, but the next chart reflects another outcome of such a policy – the United States did not witness a single recession during the past decade. This is a historic record never before witnessed since such data has been recorded in the United States.

U.S. Economy – Historic Decade of No Recessions



Sources: Clearstead, St. Louis Fed, National Bureau of Economic Research, Groningen Growth and Development Centre-Maddison Project Database. Past performance is not indicative of future results.

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THE LAW OF UNINTENDED CONSEQUENCES

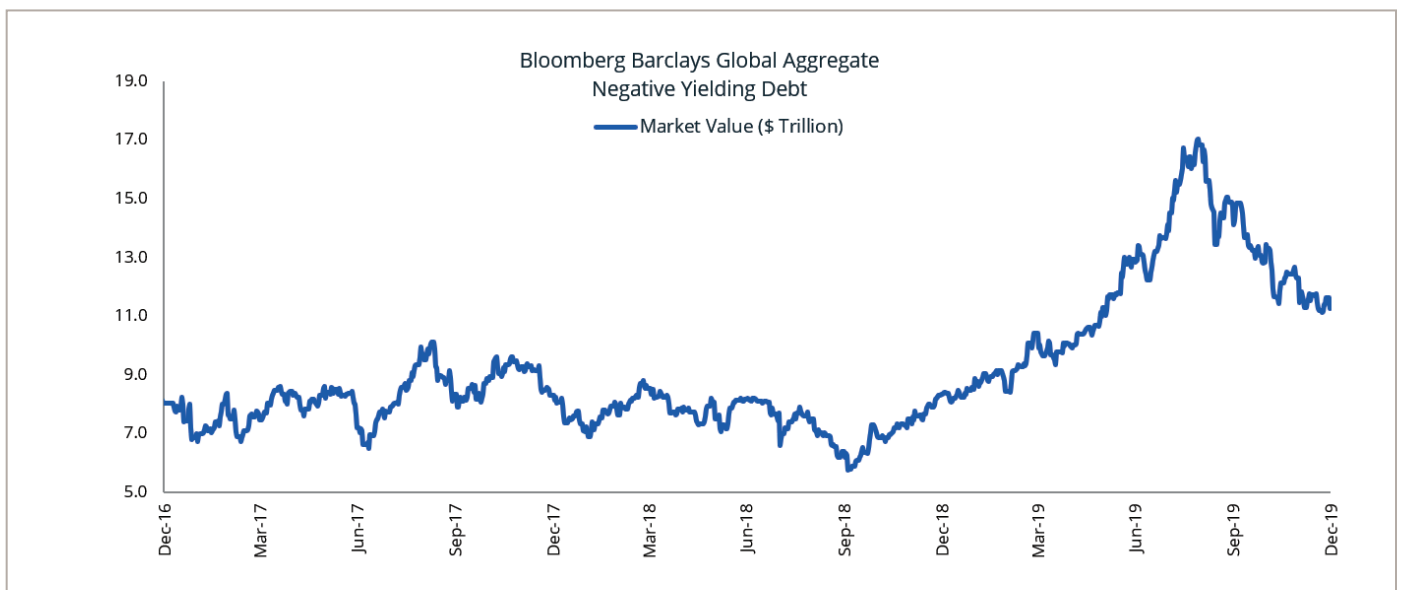
There is no doubt inflation-fighting policies have been favorable for financial markets, but many are questioning whether persistent low interest rates are good for the global economy. Japan has had minimal economic growth for the past twenty years while nominal interest rates have been continuously below 2% this century. Europe has been on a similar path for the past decade and neither Europe nor Japan see the light of growth in their future. The fear in the United States is that we may be following them.

An aging population, globalization, and automation are some of the reasons put forth for the slowing of the global economy, but the negative effects of low interest rates should also be mentioned. In Japan, low interest rates and an unwillingness to let companies fail has contributed to the proliferation of “Zombie” companies. Zombie companies are leveraged businesses that after covering variable and fixed costs have only enough funds to service the interest on their loans, but not pay down the debt itself. Low interest rates and creditors satisfied with essentially maintaining perpetual loans keep the companies alive. Political leaders encourage such behavior and monetary policy facilitates the process. Recessions can be viewed as a cleansing process that weed out the bad and allow the good to flourish. In the current environment, unprofitable and poorly run companies are allowed to survive, which perpetuates a slow growth economy and keeps interest rates low. Without the painful cleansing function of the business cycle, low and slow growth is expected to persist. As the sports saying goes, “No pain, no gain.”

THE INVESTMENT IMPLICATIONS

The willingness of monetary authorities (Central Banks) outside the U.S. to pursue growth at any cost and to create new tools (e.g. quantitative easing) to help them in their efforts has led us to financial market La La Land – the world of negative interest rates. In today's financial markets bond buyers are knowingly and willingly purchasing global government debt that guarantees they will receive less than what they paid. As the following chart illustrates, there are trillions of dollars of securities trading at yields less than zero.

New Terminology: Negative Yields



Sources: Clearstead, Bloomberg.

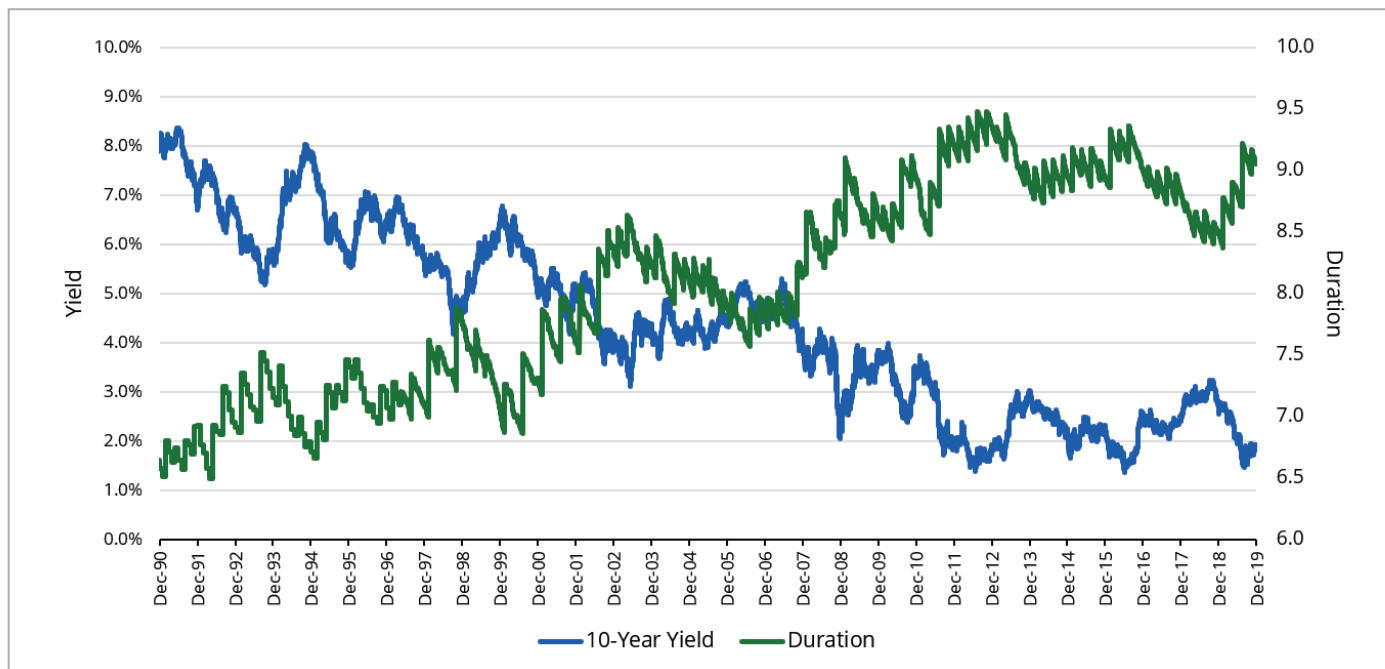
Four decades ago, I would have been terminated for contemplating such a notion, but today I need to understand how to incorporate negative yields in my analysis. To be honest, this is not something that just happened in 2019. The steady decline in yields has coincided with a rise in duration. The duration value is a measure of the average life of the cash flows of a security. As coupon rates go down, the average life of the cash flows back to the investor extends. As such, duration

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is a rough measure of the sensitivity of the price of a bond to a change in interest rates. Generally, for every 1% change in interest rates, a bond's price will change approximately 1% for every year of duration. For example, if a bond has a duration of ten years and interest rates increase 1%, the bond's price will decline by approximately 10% (1% x 10 years). Similarly, if interest rates fall by 1%, the same bond's price will increase by about 10% (1% x 10 years). As the following chart illustrates, as the yield on 10-year U.S. Treasury bonds has declined the bond's duration has increased.

New Challenge: Yields Decline > Duration Increases



Sources: Clearstead, Bloomberg.

Let's look back over the past four decades and see the impact on fixed income investing of declining interest rates. The following chart assumes a purchase of a 10-year U.S. Treasury bond with a coupon equal to the average yield for the decade. Like the chart above, as the average yield declined, the hypothetical bond's duration increased.

Lower Coupon Income Diminishes the Cushion to Absorb a Rise in Yields

Time Period	Average Yield	Duration	Purchase Price	Price if Interest Rates Increases by 1%	Coupon Income*	Value One Year Later
1980's	10.58%	6.08	\$100	\$93.92	\$10.58	\$104.50
1990's	6.65%	7.22	\$100	\$92.78	\$6.65	\$99.43
2000's	4.43%	8.01	\$100	\$91.99	\$4.43	\$96.42
2010's	2.38%	8.85	\$100	\$91.15	\$2.38	\$93.53
12/31/2019	1.92%	9.06	\$100	\$90.94	\$1.92	\$92.86

*Assume coupon income = average yield.

Source: Clearstead, Bloomberg.

Time periods: 12/31 of each starting period to 12/31 of ending period (i.e., 1980's = 12/31/79 to 12/31/89). For illustrative purposes only.

Now skip forward one year and assume interest rates rise by 1%. The first observation is that the price decline is greater as duration increases. But the real impact is the decline in coupon income. A bond investor traditionally viewed coupon income

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as the cushion to absorb price declines due to rising interest rates. The cushion is disappearing, and the risk associated with longer maturity securities has materially increased. Now imagine a bond with negative income. The cushion for price declines has not only disappeared, but loss is guaranteed. This is already happening in the global bond market, and if the Federal Reserve were to explore negative rates, risks would increase in the domestic bond market as well.

CONCLUSION

In a diversified portfolio, fixed income investing serves to diversify an equity market decline, provide income, and preserve capital. To achieve portfolio diversification, I have been trained to buy government bonds to hedge against equity risk. In a negative interest rate environment, this training would lead me to buy government bonds, providing no income and guaranteed to return less than I paid. If this sounds confusing, it should, because it does not make sense to me to call something an “investment” that is guaranteed to lose money.

In the past four decades, we saw the transformation of central banks as more effective at fighting inflation and stimulating the economy, but we have also arrived at a point where interest rates in certain parts of the world have breached 0% and gone negative. These negative yielding bonds create challenges for investors, but due to the sheer volume, they are here to stay and are a part of the investing landscape. The financial markets over the last few decades have met the needs of both aggressive and conservative investors, and I believe that financial markets will continue to reward disciplined investors with a focus on a clearly defined investment strategy to meet long-term goals. There is no rule that says I have to buy negative yielding bonds for any strategy, but there is a need to understanding today's fixed income environment. If I could fall in love with “junk” bonds, which I thought impossible decades ago, I could learn to live in a world that creates negative yielding bonds.

Sources:

- (1) U.S. Treasury 10-year Treasury yield fell from 2.69% on 12/31/2018 to 1.92% on 12/31/2019.
- (2) Bloomberg.
- (3) Bureau of Labor Statistics Data.

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Performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

December 31, 2019		1M	3M	12M	YTD
US Large Cap	S&P 500	3.0%	9.1%	31.5%	31.5%
US Small Cap	Russell 2000	2.9%	9.9%	25.5%	25.5%
Developed Intl	MSCI EAFE	3.2%	8.2%	22.0%	22.0%
Emerging Intl	MSCI Em Mkt	7.5%	11.8%	18.4%	18.4%
Real Estate	NAREIT	0.8%	0.5%	28.1%	28.1%
Core Fixed	BarCap Agg	-0.1%	0.2%	8.7%	8.7%
Short Fixed	BarCap 1-3Yr	0.2%	0.6%	4.0%	4.0%
Long Fixed	BarCap LT G/C	-1.1%	-1.1%	19.6%	19.6%
Corp Debt	BarCap Corp	0.3%	1.1%	13.8%	13.8%

Source: Bloomberg

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