Economic & Market Update, March 2016

Negative Interest Rate Policy

By Richard Morey

This is a report I never wanted nor expected to write. The topic dominating the economic world these days is "Negative Interest Rate Policy" or NIRP. When I speak to clients about this they look at me like I must be crazy for believing we may end up with negative interest rates here in the United States. Unfortunately, this is exactly what several of the Federal Reserve Board Governors are saying they may do. This is being echoed by CEOs and other top executives of several of our largest Wall Street banks.

First we need to define Negative Interest Rate Policy or NIRP. It begins when a central bank starts to charge banks for money they have deposited with the central bank. All of the Wall Street banks have large amounts of money "parked" in accounts at the Federal Reserve Board. Some of this money is required to be there, as banks have reserves they must keep with the Fed in case they should experience large losses and need the money. They also have "excess reserves," cash the banks received when the Fed printed money to buy bonds from the banks. So the Fed starts to charge the banks for their excess reserves to try to get them to loan this money out.

The central bank also hopes this negative interest rate will then "trickle down" to regular bank deposits. If it does, the banks begin to charge their customers on their savings and checking accounts. CD rates can also go negative. In this scenario, you buy a one-year CD with $100,000, and the bank promises to give you back less than $100,000 one year later. Central banks love this idea, as it could lead people to withdraw their money from the banks and spend or invest it somewhere else, thus leading to economic growth.

KEY TAKEAWAYS

- Central Banks are using policy tools of desperation in Europe, Japan and China.
- Our Central Bank, the Federal Reserve, is also contemplating NIRP (Negative Interest Rate Policy).
- NIRP hurts Banks and Savers - hopefully this discussion ends and implementation is abandoned.
- One Bright Spot if NIRP were to happen – the bonds we own will soar in value.

Please note this is actually a very complicated process, and I am simplifying it in this description. The basic theory with NIRP is that it incentivizes the banks to loan out more money and their customers to withdraw their money from the banks and spend it. This leads to an immediate spike in financial activity and the economy takes off. This is the theory, now let's look at reality.

I planned to present a detailed theoretical explanation as to why NIRP is insane. Having read the views of dozens of economists this year, I must report there is no straightforward explanation as to the effect NIRP has on an economy. This is due to the fact it has basically never been tried, as until recently all economists knew it was such a destructive idea no reputable person would ever consider it.

From the broadest perspective, NIRP destroys key aspects of a capitalist economy. Most of our business models are based on the notion money has value. Businesses have to pay to borrow money, with the best businesses being able to pay less while companies with inferior finances have to either pay more or seek other forms of funding. This natural process funnels finite resources to the better companies. The best companies succeed in a capitalist system while the weaker ones go out of business. Taken to its extreme (which is already beginning to occur in Europe), with NIRP businesses can actually get paid to borrow money. Yes, that is correct. A company borrows a billion dollars, pays not a penny in interest, and then when they have to repay the loan they give back less than a billion dollars to the lender.

NIRP is particularly destructive for banking. Banks are supposed to make their money by charging more on their loans than they pay out to their depositors. If banks are paying people 2% on their savings, they charge 5% on their loans and make the 3% difference. NIRP destroys this basic concept. They lower the rates they charge lenders, as they need to get their extra money out the door in order to avoid paying the central bank for parking it. Let's say they start charging borrowers 2%. In order to make their 3%, they then need to pay their depositors a negative 1%. But their customers then begin to withdraw their money in cash. As the rate goes more and more negative, bank customers flee with their cash and the banking business model implodes. This fact is the reason why the Fed might not implement NIRP, as to date they have always done exactly what the banks want them to do.

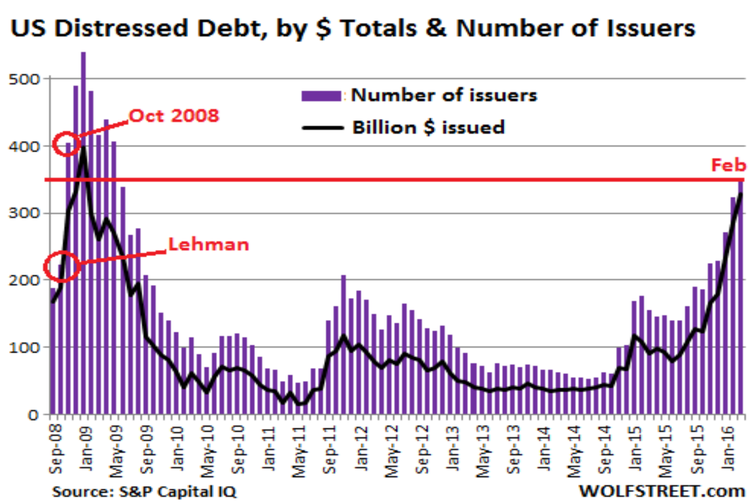
That's the very simple description of NIRP. While U.S. investors seem to believe this could never occur here, right now Europe and Japan have negative interest rate policies in effect. While figuring out how NIRP *might* work can be difficult, we can actually see what it does by looking overseas. While pretty much every knowledgeable person knows NIRP is ludicrous, most have different perspectives. But all agree it is particularly terrible for banks. In Europe they began NIRP in the fall of 2014. Since that time their bank stocks have crashed by approximately 40%. Japan began NIRP in January of this year. Within 3 weeks their bank stocks had dropped by 28%. These results certainly appear to corroborate the idea NIRP is bad for banks.

So NIRP damages (destroys?) banks, but perhaps it will lead to increased lending and spending and will therefore be worth the risk. In terms of lending, here is the first line of a Reuter's article describing the state of lending in the Eurozone: "Lending to Eurozone companies slowed sharply while a broader indicator of money circulating also fell in December, the ECB said on Friday, suggesting that credit to the private sector is still in the doldrums despite rock bottom interest rates." With a full year of NIRP under their belts, lending in the Eurozone went flat.

We would expect NIRP to also have no impact on lending here in the United States. Banks already have trillions of extra dollars available to lend, and rates are already historically low. Corporate lending has already doubled over the last six years, with a substantial amount of this money going to companies who may never be able to repay the principal. Of course the banks would not like to have to pay to keep their excess reserves parked at the Fed, but this would be better than lending it out to companies who will never repay it.

Now let's look at consumer spending. Over the last year, consumer spending in the Eurozone increased by 2% (according to the European Central Bank). This sounds fine until you recall "normal" consumer spending equals at least 4% annual growth.

In other words, NIRP has done nothing for the Eurozone economy except weaken their already endangered banks. In reality this is probably for the best. If NIRP actually worked as advertised the outcome would be even worse. Here in the U.S. corporate debt has doubled and now the percentage of corporate loans that are distressed (i.e. may not be able to repay the money) has exploded upwards as you can see in the chart below:



Our bad corporate debts are now in imminent danger of default, leading to bankruptcy, exceeding the levels breached after Lehman went under in the fall of 2008. Given this backdrop, do we really want our banks to dramatically increase their lending to companies already in danger of defaulting on their current loans? Similarly, punishing savers by taking some of their money each year instead of paying them interest would do nothing positive. Yes, they might spend a little more for a month or two. And some might take the money out of savings to invest in risky assets. However, our citizens are already over-indebted and need to save more money, not less. Encouraging savers to blow their little nest-eggs solves nothing and puts them in greater financial jeopardy.

In summary, we know NIRP hurts banks and savers. We also know that if it works as intended the results are even worse. Given these facts, why in the world are central bankers' intent of using this absurd "tool?" The answer was given by a central bank official who basically said, "Yes, NIRP is crazy, will definitely hurt the banking system, and probably won't do anything good for the economy – **but we have to do something**." We have a policy we know damages us, which causes even more damage if it actually "works," but we are going to do it anyway lest people realize there is nothing our monetary heroes can do to save us from the trillions and trillions of bad debt we have created to cover up the bad debts of the past. That certainly sounds like a rational policy!

From another perspective, NIRP is dangerous for markets because all rational people know it makes no sense. As a result, the public is likely to (finally) realize the central bankers running – and abusing – our economy truly have no idea what they are doing.

On the bright side, there is exactly one asset that is nearly certain to deliver large profits under NIRP. The highest-quality bonds – particularly government bonds or Treasuries – roar when NIRP is inflicted on an economy. This makes perfect sense. Right now 10-Year U.S. Treasury bonds are paying approximately 1.8% in annual interest. This doesn't sound like much, but if the banks are charging you to loan them your savings, 1.8% is a big return. In response, investors will pour their money into Treasuries, driving up prices. Assuming the Fed does institute NIRP – as many now expect them to do – the 10-Year Treasury should go up around 20% in price, with 30-Year Treasuries (which we own through our largest fund, Wasatch- Hoisington U.S. Treasury fund) rising approximately 40% in price. NIRP will therefore make our clients at Secure Retirement a lot of money, though we would prefer not to make our money as a result of the Fed driving another stake through the economy.

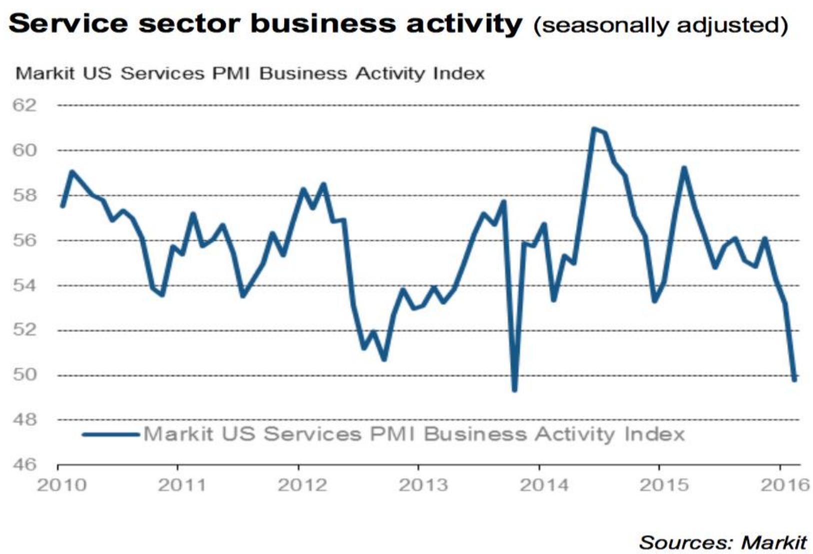
Unfortunately, after NIRP doesn't help the economy, the Fed has one more tool to inflict on us. Called "helicopter money" by ex-Fed Chairman Ben Bernanke, this final act of central bank stupidity will be the most damaging of all. With helicopter money Congress approves sending waves of money directly to our citizens. Since we don't have the money due to our huge annual deficits, the Fed prints up new money and Congress then authorizes sending it out, either directly as a check to everyone or through tax holidays. I would actually rather use this method than what has been used to date consisting of programs to funnel money only to banks and the wealthiest of our citizens. From the beginning helicopter money was the only sure way to spark inflation, which is a primary Fed goal. This is a case of "be careful what you wish for," as one of the few things worse than the economic status quo is out-of-control inflation.

I am afraid the Fed will keep acting until all the bad debt in our economy comes crashing down. In the process, banks and individual investors will lose a few trillion dollars. This is absolutely inevitable, and the sooner it occurs the better it will be for our nation. My prayer is that we then restructure our financial and monetary systems, stopping the Fed from distorting what was once a relatively free market economy.

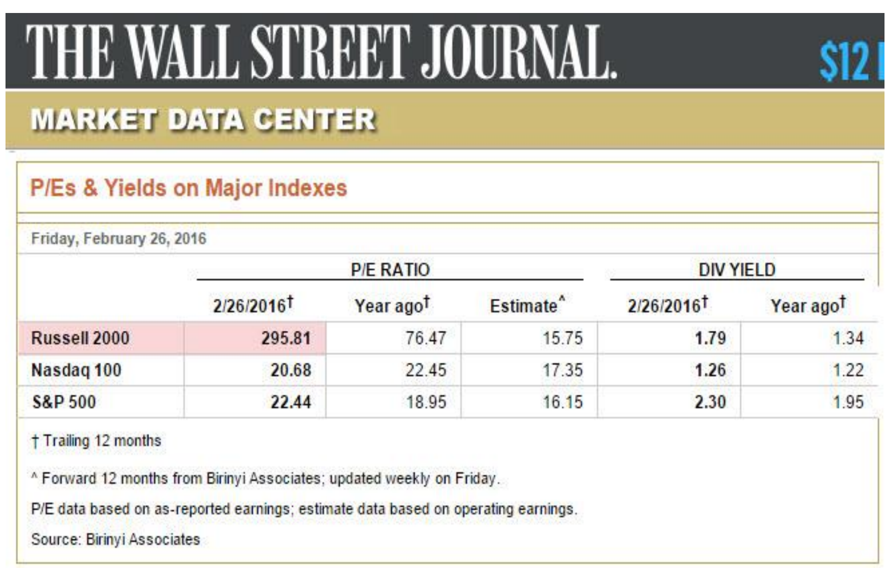
Economic Update

This will be short, as we'll be covering the economy in detail with next month's quarterly report material. As I write this on February 1, the stock market is shooting up. One headline reads: "Worst Global Economic Data In 4 Years Sparks Stocks' Best Day In 6 Months." The data in question was the February report on manufacturing. This data showed that manufacturing in the U.S. **shrank** for a 5th straight month in February. The news was even worse for much of the rest of the world economy.

Manufacturing has now been in a recession for months. The last leg holding up the wobbly economy has been the larger services sector. This ended recently, as the chart below shows the services sector is now contracting – any reading below 50 = contraction. (Note: the drop you see in late 2013 was a one-month decline connected to the government shut-down.) There has never, ever been a time when both manufacturing and services were contracting in which the U.S. economy was not already in a recession.



Finally, we have the economy shrinking and most likely now fully in recession with stocks still more over-priced than at any time in history except the end of the tech bubble in 2000. I have written about this fact many times. What you don't hear in the financial media these days is any mention of the actual levels of over-valuation in the stock market. The chart below shows the price-to-earnings ratios of U.S. stock indexes. Note the P/E Ratio of the 2000 smaller company stocks in the Russell 2000:



THE WALL STREET JOURNAL.

MARKET DATA CENTER

P/Es & Yields on Major Indexes

Friday, February 26, 2016

	P/E RATIO			DIV YIELD	
	2/26/2016†	Year ago†	Estimate^	2/26/2016†	Year ago†
Russell 2000	295.81	76.47	15.75	1.79	1.34
Nasdaq 100	20.68	22.45	17.35	1.26	1.22
S&P 500	22.44	18.95	16.15	2.30	1.95

† Trailing 12 months

^ Forward 12 months from Birinyi Associates; updated weekly on Friday.

P/E data based on as-reported earnings; estimate data based on operating earnings.

Source: Birinyi Associates

No, that is not a typo. The P/E Ratio of the Russell 2000 – 40% of the commonly traded stocks in the U.S. market – is 295!!! Keep in mind the historic average P/E for these stocks is around 15. What does this mean for investors? The answer is simple – if you own small-cap stock funds, sell them right now.

You'll also notice the P/E for the S&P 500 index of large U.S. corporations is 22.44. In a weakening economy in which corporate earnings have been going down quarter after quarter, a reasonable number here would be 11.22, which means the price of the stocks will be cut in half. I still do not know when this will occur, but it is as certain as death and taxes. What truly concerns me for investors is history. In the future we will look back at the time beginning in 2000 and realize we were in a long-term secular bear market. No, it did not end in 2009. These types of bear markets have never ended throughout history until the P/E ratio for the entire U.S. stock market was in single digits – around 7 on average. To get there the stock market would need to drop by nearly 70%. Hopefully we never see these levels for stocks, but history suggests we will. I say 'hopefully' because, while our clients at Secure Retirement would make a lot of money, retirement accounts in this country would be devastated. Most would never recover.

China's Shadow Banking Nightmare

In case the information about the U.S. economy discussed above is not sufficiently concerning, we'll end this month's report with a look at what may be the biggest risk to the world economy. In China investors (mostly individuals) have put over $10 trillion (some believe $15 trillion) into what are called "Wealth Management Products." These are typically one-year investments paying 8-12% "interest." They are sold by bank officials as being comparable to CDs, with guaranteed principal backed by the government. However, if they read the contract they would discover the government does not guarantee a penny of the money.

The banks have then taken this $10+ trillion and loaned it out, primarily to real estate developers. There are two almost unimaginably large risks here. One is that the loans are typically for 5 or more often 10 years, while the money came from one-year investments. The other problem is that, conservatively, the real estate involved probably has losses of $3.5 *trillion* or more! This is one-third of the entire nation's GDP. At some point the public may figure out these investments are losing money and are not actually guaranteed by anyone. The investors will then demand their money back after the one-year time period, and nobody else will invest to cover these withdrawals. But the banks won't be getting repaid for years. Where will they come up with trillions of dollars they do not have? Yes, the Chinese government still has around $3.3 trillion in foreign reserves, but this has been leaving the country to the tune of $100 billion a month lately. And they need over $2.5 trillion just to keep the country's financial system operating.

The answer is: financial crisis. The moment the Chinese individuals who invested their money into these Wealth Manage Products decide they want their money back, the Chinese Ponzi scheme of bad debt will come crashing down, along with the bad debt throughout the world.

Conclusion

That's about all the sobering economic news I can share in one report. Our financial mantra remains the same: You cannot fix a debt crisis caused by too much bad debt by creating a massive amount of new bad debt. Here at Secure Retirement we hope this lesson is learned after the next market meltdown. Of course, hope is not an investment strategy. Our strategy is to not only protect our clients' principal but deliver strong profits throughout the upcoming difficult time period for the economy and (stock & junk bond) markets.