American Heritage Financial

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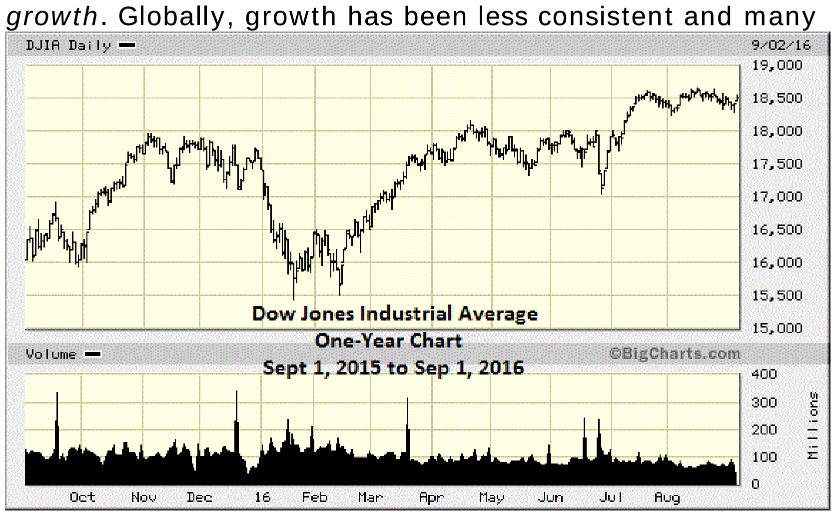
Upside Down

This month we discuss the massive monetary stimulus which still remains all these years after the financial crisis.

- We will attempt to make sense of ***negative interest rates***.
- We look at the ***risks*** negative and low interest rates have created.
- ***How do we invest in this tenuous environment?***

It has been seven and a half years since the bottom of the financial crisis that caused the "Great Recession." Since those dark days of early 2009, the economy—at least the U.S. economy—has experienced steady growth; stubborn and at a rate far lower than a normal recovery but, still, *consistent growth*. Globally, growth has been less consistent and many economies still struggle with near-recession conditions. Yet, throughout the world, including the U.S., there remain deep scars and unhealed wounds these seven-plus years later.



Today's problems are aftereffects of the financial crisis. To deal with the spectacular collapse of 2008 and prevent a return to the Stone Age, governments around the world bailed out banks and the private sector. Those bailouts and subsequent stimuli resulted in monstrous government debt. Countries issued and bought debt to inject liquidity into their economies and the result is the world is awash in cash—or "liquidity."

A lot of things about today's environment don't fit economic theory. Ballooning government debt and massive amounts of cash chasing goods would normally bring inflations and higher – much higher – interest rates. But central banks (including our Federal Reserve) have kept rates artificially low and aggressively purchased bonds, driving interest rates down to… well, today a quarter of global government debt "pays" negative interest.

Negative interest rates is an upside down concept. Normally, people save by foregoing current consumption (not buying a new car or fewer trips to restaurants) and lending those savings. In exchange for the sacrifice, the lender receives interest payments. With negative interest rates something very different happens: Let's say you lend $100 to your neighbor. A year later, the neighbor knocks on your door and repays that $100 loan in full by writing you a check for $95. You had to pay him $5 for foregoing your consumption of $100 for a year. That is negative interest rates. Try to find that explained in an economics book, or try to explain it to the nearest 5 year old!

The point for investors is this: negative and near-zero interest rates show central banks' desperation to avoid deflation and more importantly they **highlight the bleak state of the global economy**. Low and negative interest rates should reduce savings and stimulate spending. In fact, the opposite has happened—the savings rate has gone up and spending is lackluster. Perhaps it is due to shoring up personal and corporate balance sheets in response to the crisis, perhaps it is a lack of confidence in the future, it could be due to ever-changing and often stifling regulation as well as demographics or other issues. Economists don't have clear answers to exactly what is causing this upside down phenomenon. But the point is worth repeating: If the global economy was doing great, interest rates would not be where they are today!

There are numerous issues tied into the weak global economy including a long list of questions surrounding Brexit, Italian and Greek economies on life support, major questions about China's economy and—at home—an upcoming election in which most of us just want to vote “neither.” All of these issues deserve our cautious attention but there are three which deserve our laser focus:

- Number one is the **risk in ultra-low interest rates**. Investors are not being compensated (in terms of interest received) for the risk of lending money or owning bonds because bonds lose significant value when rates rise. And interest rates will rise again—the big question is when.
- Low interest rates and massive liquidity have created a search for yield which has inflated values in parts of the stock and real estate markets—the primary places investors park their excess cash. High quality, high dividend stocks (long one of our favorite areas of the market) have benefited greatly but **many high quality, high dividend stocks are overvalued** due to the search for yield.
- Last, we must watch the **tenuous global economic situation**. The world did survive the financial crisis and, in most countries, conditions are much better than before. Still, there remain huge risks such as those mentioned above and growth remains stubborn. In addition—always expecting the unexpected—we need to be remember that explosive growth and rampant inflation could suddenly ignite should the massive stimulus ever take hold.

While these, and many other issues might keep us up at night trying to understand how to maneuver possible shifts in the economic landscape, we believe it is too soon, and highly imprudent, to make wholesale adjustments to investment strategies in anticipation of the potential risks. We suggest you stay right-side-up as you enjoy the cooling Fall weather and we will continue our work to help you achieve your long-term financial goals.

Best regards,

Ted Ingraham

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Questions or comments?
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