

Preparing for the Correction—Part VI The Specter of Negative Interest Rates

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September, 2019—For this letter, I open with a couple of prescient quotes written more than 70 years ago by Professor Ludwig von Mises, the “founder” of the Austrian School of Economics:

The wavelike movement effecting the economic system, the recurrence of periods of boom which are followed by periods of depression is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion.

True, governments can reduce the rate of interest in the short run. They can issue additional paper money. They can open the way to credit expansion by the banks. They can thus create an artificial boom and the appearance of prosperity. But such a boom is bound to collapse soon or late and to bring about a depression.

It's that last sentence there that bothers me. Of course, not everyone agrees with Professor Mises, but history sure does. When has the market gone up forever without an eventual—and significant—downturn? The chart here to the right is the total US stock market just since 1990.

You can see the “wavelike movement” Mises is referring to. You also can't miss the great boom that has been raging since 2010.

“But such a boom is bound to collapse soon or late...”

With 25 years of experience in the financial industry, I refuse to

accept conventional thinking which says to just allocate, diversify, and wait it out. This essentially means, “take the losses and ride it out; it will eventually come back.”

Conventional thinking appears to be lost in the past--the good ole days. It used to be true that an economist could look at fundamental things like earnings, sales, profits, forward looking estimates, price to book valuation and other rudimentary empirical data. Imagine that?



¹ Ludwig von Mises. Human Action, p. 570; p. 572

² Ludwig von Mises. Omnipotent Government, p. 251

Today, what is Economics? Hanging on every word of some central banker from the ivory halls of academia that no one ever voted for? Looking for some esoteric meaning that will indicate which way interest rates will be artificially mandated? Watching and waiting to see how the Chinese will react to the latest Trump tweet?

Fear not what happens in the geopolitical international economy—the central banks will do whatever it takes to “spur the economy.” What does that mean, exactly? It means “stimulus.” Well, what is that? It means create a bunch of new money, *from nothing*.

There are two easy ways for central banks to do this—print it, and lower interest rates. Printing can be easy for people to understand (though they never call it that) but lowering rates can be somewhat confusing. How does that stimulate growth through money expansion?

This is what Mises was talking about when he said “*they can open the way to credit expansion by the banks.*” When you borrow money from a bank, the bank actually creates 90% of the money it loans you (based on a 10% reserve requirement).

Low rates are meant to dissuade people from saving and encourage them to do two things:
(1) invest it, and (2) spend it.

It used to be true that one could lower rates to 4 or 5 percent to spur growth, but then it needed to go lower, and lower, until finally, some central banks have become so desperate that they have introduced NEGATIVE rates!

According to Deutsche Bank, there is now **more than \$15 trillion of government bonds** worldwide, or 25% of the entire global market, **trading at negative rates!**³

Rather than take my word for how crazy this is, here is an excerpt from the only fund manager in the United States to win the Morningstar Manager of the Year award for *both* an equity and fixed income fund, Robert Rodriguez, now retired:

Negative yielding debt is a concept that could only be considered rational by an academic. Given 4,000 years of human history, I’ll bet this is as faulty an idea as there ever has been and that it will be proven to be 100% hokum. Negative yields distort the entire capital asset pricing model. They undermine financial company profit models, pension fund liability assumptions, and seriously work to reduce the attractiveness of lending money and financial liquidity by eliminating the ability to do repo finance. But don’t worry, since the central banks will save the day by buying corporate debt. Isn’t that what the Japan’s central bank did, as well as the ECB? And what have these policies achieved in terms of real economic growth? Very little! And now we have members of the Fed actually discussing and agreeing that a negative rate can be effective and appropriate. In other words, penetrating the zero-rate boundary will broaden their policy options. Again, the Fed is clueless and is working with inadequate and ineffectual sets of econometric models.⁴

I couldn’t have said it better myself. On Wednesday, the Fed lowered rates again, to 2%. How much lower do they intend to go?

³ <https://www.cnn.com/2019/08/07/bizarro-bonds-negative-yielding-debt-in-the-world-balloons-to-15-trillion.html>

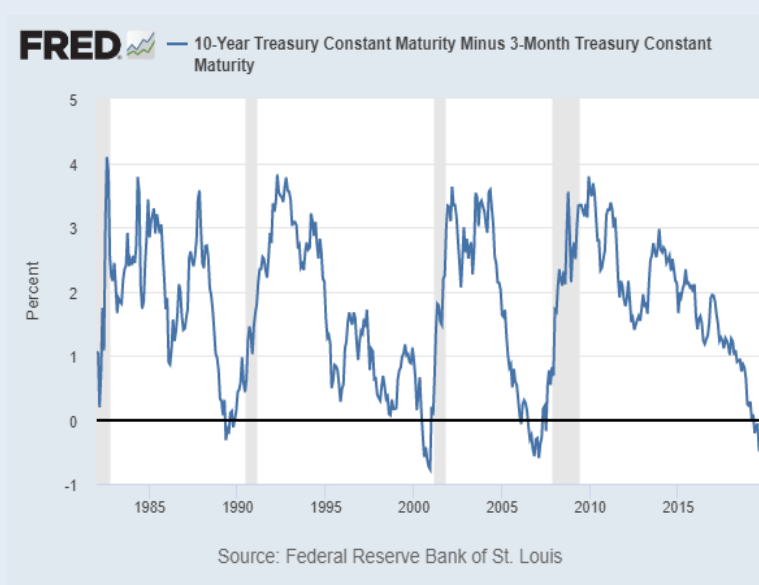
⁴ <https://www.advisorperspectives.com/articles/2019/09/09/bob-rodriguez-the-fed-is-clueless>

The inverted yield curve, which you've heard so much about, is generally seen as a harbinger of hard times ahead but is misconstrued by many. The inverted yield curve is not the cause, but rather yet another symptom of the Fed's mismanagement—and indeed, a market anomaly that proves that we do not need the Fed at all.

All of the other rates, the 3-5 year, the 5-7 year, the 10-year are all driven by market forces--supply and demand. But the ultra-short-term rate, the Fed funds rate, is not be driven by market forces but by committee, what F.A. Hayek calls "The Fatal Conceit."

Think about buying a CD. The longer the term of the CD, the higher the interest rate that it pays. So, a 6-month CD would pay less than a 5-year CD, yes? We have all had that experience.

But what happens when a 10-year treasury bond pays *LESS* than a 3-month treasury bond? That's what is meant by "inverted yield curve." But I just call it "crazy."



The chart to the left here represents the 10-year treasury yield subtracted from the 3-month treasury yield.

The places where the blue line dips below zero are times when the 3-month pays more.

This is not natural and can only occur because of manipulation on the short end.

Notice also that every dip below zero is followed by a grey shaded area. What does the grey shaded area mean? It means a recession. Lost jobs, lost wealth, lost time, lost lifestyles.

If we were living in a vacuum economy, where we are the only currency in the vacuum, then it matters little what others outside the vacuum are doing. But since that is obviously not true, money often goes where it's treated best. With the rest of the developed world at nominal or negative rates, and us over here in the US of A paying 2.25% on the safest investment in the world, no wonder our dollar is so strong and our treasuries are so high.

Finally, the one empirical factor that does seem to track the general market is corporate earnings.

The chart here shows the relationship between corporate earnings (the red line) and the overall growth of the S&P 500 (the blue line).

So far, so good. But there are signs that earnings may be slowing.

Notice the red line doesn't quite make it all the way to the right side of the chart. This is due to a lack of information as we only get corporate earnings reports on a lagging basis.

All of this taken together means that we are seriously concerned about the future health of not just the global, but also the domestic, economy. If we need so much stimulus in a time like this--when things are great--then what will be needed the next time a recession ensues in earnest? Can a recession be averted forever? Professor Mises says "no." We wholeheartedly agree.

Accordingly, we have already begun taking action to protect our clients' portfolios. We have been identifying all-time highs in certain equity positions and reducing our exposure by about one third. This continues as I write this letter. Last year, we jettisoned all our high-yield bonds and all our corporate bonds, for reasons that I outlined in my last letter, *Preparing for the Correction, Part V: Beware Fallen Angels*. If you did not get a copy, please contact our office or visit our website, www.magellanplanning.com. Look for Newsletters under Learning Center.

Our destination for all that money has been, and continues to be, treasuries. Except that currently the price of treasuries has spiked for reasons mentioned earlier. Rather than buy in at a high there right now, we are content to safe harbor in a money market earning a smidgen under 2%. This will give us the liquidity to buy in to treasuries if they drop, or back into equities if a serious correction occurs.

Looking forward, Xi and Trump plan to meet in October in Washington to hopefully resolve some of the issues.⁵ The Chinese are having serious problems with Hong Kong and are terrified of the democratic contagion reaching the mainland, which becomes more probable the longer the demonstrations continue. Trump, already in re-election campaign mode, wants a great deal to vaunt. So, both men have a vested interest in making a deal.

Whether it's the deal of the century or not, the initial global market reaction should be jubilation. This will be our opportunity to sell more equities and possibly buy treasuries, assuming their price has sufficiently dropped.



⁵https://www.washingtonpost.com/world/asia_pacific/china-us-to-resume-trade-talks-in-washington-in-october/2019/09/05/77acf236-cf82-11e9-9031-519885a08a86_story.html?noredirect=on

Thereafter, we believe no amount of stimulus will be able to counter the coming wave of unintended consequences from negative rates. We don't know when or exactly how, or even the spark to light the fuse, but only a fool would ignore these ominous signs.

If you are managing your own 401k or other retirement plan, you may want to consider a similar action. You may not have a short-term government securities fund, so you may want to consider instead your stable value fund.

Ask yourself this question: "Can I sustain my lifestyle for five years without having to sell anything at a loss?" If the answer is "no" or more often "I don't know", you may want to check your strategy. Contact our office for some helpful literature and tools.

For everyone else, enjoy your autumn and take a trip to the British Isles. With the threat of a hard Brexit looming, the pound sterling is exceptionally attractive. In fact, I've never seen a better time to go.

And as always, we truly appreciate having you as a member of our family!

Very Truly Yours,

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

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