Redstone Advisors

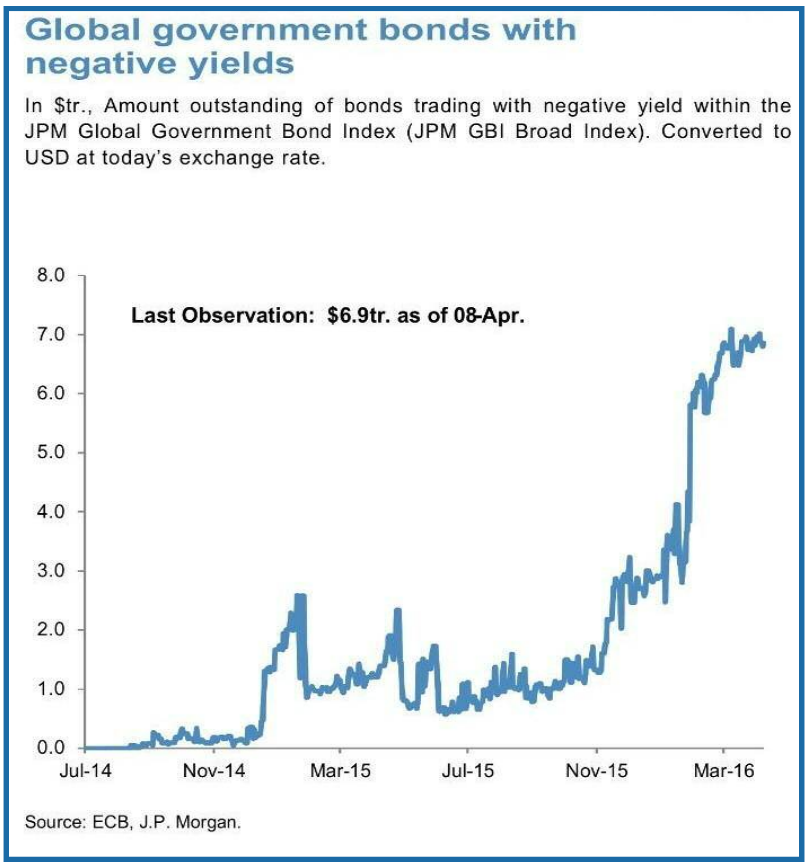
Economic and Market Review

First Quarter 2016

> ***"We're here in an environment where central banks have to learn one message, and that is that negative interest rates are not desirable and they are not workable."***
>
> Hans Redeker, Morgan Stanley

The first quarter of 2016 mainly saw a continuation of the **low-growth, low-inflation and low-rate environment** that has lingered in the global economy. By the end of the quarter, the yield on the Bank of America Corp. Global Broad Market Index had sunk to 1.3 percent, the **lowest level in nearly 20 years of data**. It is not just a low-rate environment. Roughly a third of the world's sovereign bonds have negative interest rates, according to JP Morgan bond indexes. As of early April, that meant nearly **$7 trillion of global government bonds had negative yields**, an astonishing sum likely considered inconceivable just a few short years ago. Figure 1 shows the staggering rise during the last couple years. In late January, the Bank of Japan (BOJ) surprised markets by announcing that it would implement a rate of negative 0.1 percent on certain excess holdings of cash by private-sector lenders. At one time considered unthinkable among central bankers, the pay-to-save strategy has now been adopted in Sweden,

Figure 1



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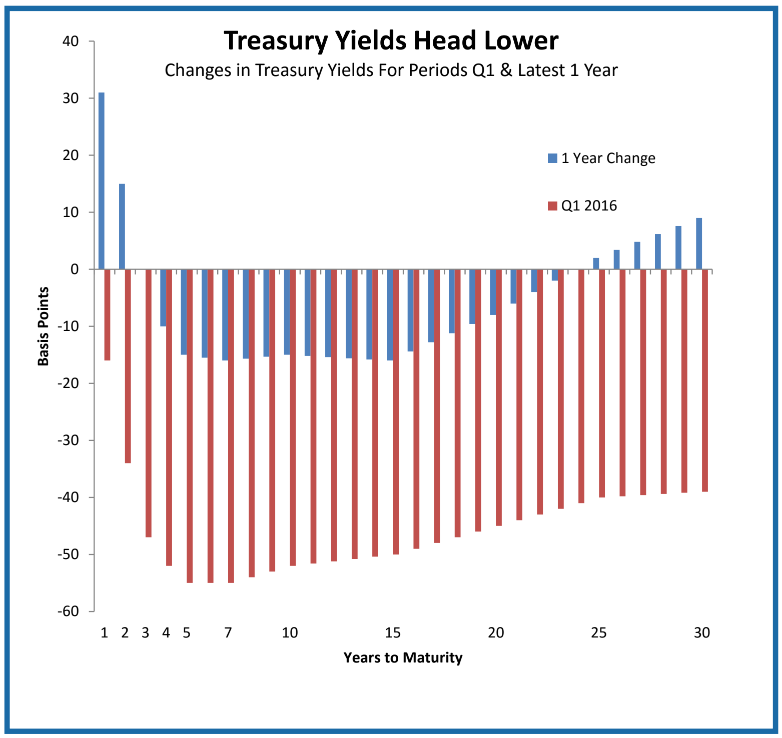
Denmark, Switzerland, and by the European Central Bank (ECB), in an attempt to get banks lending again and companies spending. Since taking the helm in 2013, BOJ Governor Haruhiko Kuroda has already pushed monetary policy to the outer limits with an aggressive quantitative easing program of bond and other asset purchases that has ballooned the BOJ's balance sheet to about seventy-five percent the size of the economy. Kuroda's exploits in unconventional central banking were designed to lift Japan out of its decades-long deflationary mire. Unfortunately, inflation remains very tepid, exports are disappointing, consumer spending is weak and business investment is subpar. Many analysts say that for an economy which has been woefully stagnant for two decades (24 years of 0.8% inflation-adjusted GDP growth), what's needed are deep, painful structural reforms led by the government. "*Monetary policy can't shoulder the whole burden,*" argued David Carbon, chief economist at DBS Bank Ltd. in Singapore. At a conference hosted by the BOJ last year, Kuroda referenced a fairy tale for inspiration. "*I trust that many of you are familiar with the story of Peter Pan, in which it says, 'the moment you doubt whether you can fly, you cease forever to be able to do it.*" Unfortunately for Kuroda, with stagnant wage growth and declining oil prices, reaching his key inflation goal looks to be an elusive fantasy. Also complicating matters is a rush by global investors to buy the yen, which is viewed as a safe currency in times of economic turmoil. The resulting rise in the yen's exchange rate has hurt the Japanese stock market and darkened the outlook for inflation. In early February, the yield on Japanese 10-year bonds dropped to zero for the first time ever and then quickly fell into negative territory. That was a clear sign that the world's central banks are seeing their carefully laid-out plans disrupted by a jittery market. The flight to quality by global investors to perceived safe assets is certainly complicating the BOJ's effort to bolster the Japanese economy. Moreover, banks are very reluctant to pass the costs of negative rates on to depositors, for fear they will pull their money out of their accounts in an old-fashioned bank run. Instead, banks are absorbing the penalties themselves, cutting into their profits. Ultra-low and/or negative interest rates weigh on banks' net interest margins (NIM), a key component of banks' future capital base. Combined with the impact of even more stringent regulation, this reduces a banks' willingness to lend to borrowers and further hampers their ability to provide liquidity to markets.

The easing actions by the ECB, BOJ, and other global central banks have in effect, kept a lid on U.S. Treasury yields moving higher. Fixed-income investors exist in a world of relative returns, and as such, s**uper low and negative global yields are seen by many bond market analysts as pulling Treasury yields lower**. Yield-hungry foreign investors continue to flock to the relative value of U.S. Treasuries, driving up the prices and lowering the yields. Treasuries underwent a strong rally in the first quarter. Changes in the Treasury yield curve for the quarter and latest one year period can be seen in Figure 2. With an alarming $7 trillion of sovereign European and Japanese debt offering negative yields, **demand for U.S. fixed income assets is unlikely to dissipate regardless of what actions the Fed takes** later this year. Importantly, the benchmark 10-year Treasury note ended the quarter yielding 1.82 percent, down from 2.34 percent at the end of 2015 when the Fed raised rates for the first time in over a decade. Fed funds futures markets have pushed back bets for when the Fed will tighten again. "*It's just a realization that we're stuck for a while,*" said Barra Sheridan, a trader at Bank of Montreal. He added, "*The U.S. cannot decouple, the Fed can't raise rates until the global backdrop improves and there really isn't any sign of that happening anytime soon.*"

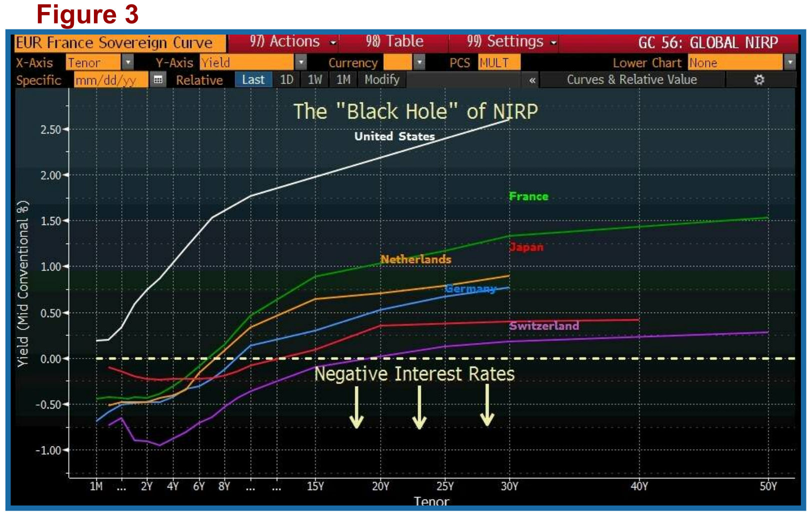
Figure 2



The policies that central banks like the BOJ have imposed, intended to spur lending, are instead unfortunately simply spurring anxiety. This past quarter, there seems to have been an **unmistakable anchor**

dragging down virtually the entire global yield structure. By the end of March, Germany's 10-year bund yielded 0.15%, the U.K.'s 10-year bond was at 1.41%, Japan's was at -0.03%, France's was at 0.48% and the U.S. was at a relatively high-yielding 1.82%. The problem, which central banks are discovering, is that it can be quite challenging to reverse crisis-era policies. Many analysts see dovish central banks and macroeconomic concerns as continuing to delay any kind of normalization. Scott Mather, managing director at PIMCO, wrote that it appears that negative rates have not been "*especially impactful in lifting growth or inflation, or in lifting expectations about future growth or inflation. Instead, it seems that financial markets increasingly view these experimental moves as desperate and consequently damaging to financial and economic stability.*" Several of the countries with negative-yielding sovereign debt can be seen in comparison with the US Treasury yield curve in Figure 3. Some critical analysts see central banks as desperately and recklessly intervening in the economies they have been entrusted to responsibly manage. **First came zero interest rate policy (ZIRP), then quantitative easing (QE), and now negative interest rate policy (NIRP) – one questionable attempt begetting another**. Essentially, QE failed to deliver strong and sustainable growth and failed to banish the specter of deflation. Critics see that just as the first two attempts failed to gain meaningful economic traction in chronically weak recoveries, the movement to negative rates will only increase the risks of financial instability and lay the groundwork for the next crisis. The implementation of negative interest rates – initially launched in Europe in 2014 and now embraced in Japan – represents a **key turning point for central banking**. Previously, emphasis had been placed on increasing aggregate demand – primarily by lowering the cost of borrowing, but also by creating wealth effects from appreciating financial assets. But now, by levying penalties

Figure 3



on excess reserves left on deposit with central banks, negative interest rates try to stimulate through the supply side of the credit equation – in essence, urging banks to make new loans regardless of the demand for such loans. Many argue that misses the heart of what precisely ails the post-crisis world. Critics say it speaks to the impotence of central banks to stoke aggregate demand in balance-sheet-constrained economies that have fallen into 1930s-style "liquidity traps." In the era of conventional monetary policy, transmission channels were largely limited to borrowing costs and their associated impacts on credit-sensitive sectors of real economies, such as homebuilding, motor vehicles, and business capital spending. As those sectors rose and fell in response to shifts in benchmark interest rates, repercussions throughout the system (multiplier effects) were often reinforced by gains in asset markets (wealth effects).

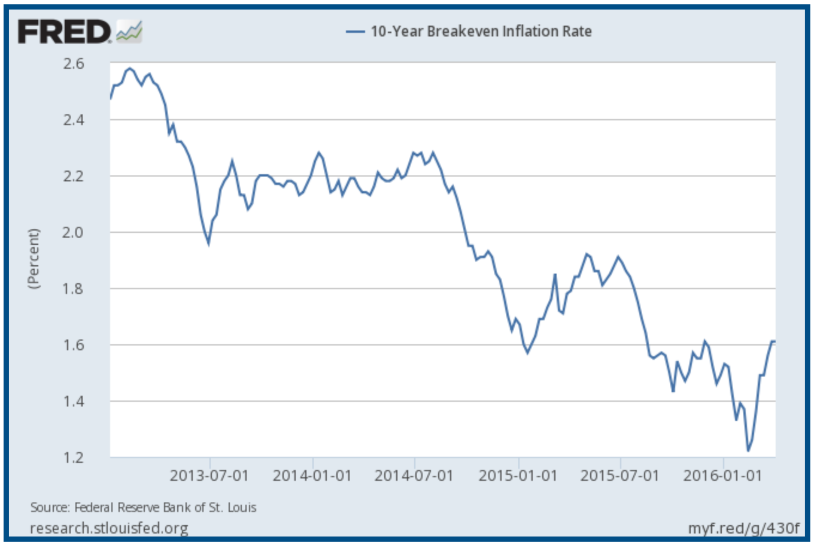
In the brave new world of unconventional monetary policy, the transmission channel runs mainly through wealth effects from asset markets. A couple of concerning complications have arisen from this approach. The first is that central banks have neglected the risks of financial instability. Drawing false comfort from meager inflation, overly accommodative monetary policies have led to huge bubbles in asset and credit markets, creating significant distortions in real economies. Second, politicians, lulled by frothy asset markets, were less likely to opt for fiscal stimulus. Without fiscal stimulus, central bankers kept their foot on the pedal by injecting more liquidity into bubble-prone financial markets – failing to recognize that they are doing little more than **"pushing on a string"** as they did in the 1930s. The shift to negative interest rates is all the more worrisome. Given persistent sluggish aggregate demand worldwide, a new set of risks in introduced by penalizing banks for not making new loans. Some say this is the functional equivalent of promoting another surge of **"zombie lending"** – the uneconomic loans made to insolvent Japanese borrowers in the 1990s. Former Treasury Secretary Lawrence Summers argues that essentially forcing firms to invest in something could create a host of adverse consequences ranging from dangerous financial schemes to more asset bubbles like housing booms that end with painful busts.

Some critics contend that as central banks become more intent on boosting inflation and growth, they are beginning to break one of the modern rules of the profession by channeling money directly to what they regard as "good" uses. Historically, the basic intention of central banks has been to adjust the overall economy while leaving the market and government to decide the best use of capital, decisions which are best left to market forces. For certain, in recent years, central bankers have been trying to push households and companies to spend more and take more risk by lowering rates, making saving less appealing and pushing investors into riskier assets. The meager growth they've generated means a downside shock still threatens to sink the world into recession. A major concern is that policy makers are kicking the can down the road, putting off the pain for now while adding to the difficulties they will face later.

The Treasury market has been sending some cautious signals this past quarter. The differential between short and long-term Treasury yields has narrowed so far in 2016 and many analysts see the **yield curve as likely to flatten further**. In mid-March the gap between yields on Treasury 2-year notes and 30-year bonds narrowed to 175 basis points, the lowest level since 2008. While short-term rates tend to be influenced by the likely path of Federal Reserve policy, long-term rates are seen as a signal about the expectations for economic growth and inflation. In recent years, the yield curve has been kept artificially steep by extraordinary central bank policies, such as the Fed's numerous rounds of QE that consisted of massive amounts of bond purchases. The flattening yield curve seems to suggest that the market is skeptical and remains concerned that the Fed cannot sustainably raise interest rates. Also, as yields on trillions of dollars of Eurozone and Japanese bonds sink further below zero, demand for positive-yielding Treasuries may mitigate any move by the Federal Reserve to push U.S. interest rates higher. In February, Japanese money managers plowed a net 3.56 trillion yen ($31.3 billion) into bonds abroad, the most since August 2010, according to the Ministry of Finance.

In early March the European Central Bank (ECB) made an unexpectedly aggressive move to boost inflation and economic growth in the nineteen countries that make up the Eurozone. The ECB decided to cut its main benchmark rate to zero from 0.05 percent, lowered the rate on deposits from commercial banks at the central bank to negative 0.40 percent from negative 0.30 percent, increased its monthly bond purchases to 80 billion euros from 60 billion euros, and added corporate bonds to the assets it can buy, expanding the potential scope of the asset purchase program. Many economists see no guarantee that this latest 'bazooka' will be any more effective than previous ones in securing the strong and sustained growth required to eliminate the threat of deflation in the currency union and allow the peripheral countries to tackle their unique debt problems. One significant effect of negative rates and bond purchases has been a lower euro. The ECB insists it does not use monetary policy to manipulate the currency lower, but as of quarter end, the euro has fallen to about $1.14 from around $1.40 back in 2014. **Ultra-loose policies by the ECB and BOJ certainly have the potential to undermine any bias the Fed has towards tightening**, particularly if the euro and yen continue to weaken and the dollar's strength blunts inflation and growth. As of the end of March, the gap between yields on Treasury Inflation-Protected Securities (TIPS) and nominal 10-year notes, known as the break-even rate, indicated that inflation will average about 1.6 percent over the next decade. That is below the Fed's targeted inflation level. A graph of the break-even rate going back to 2013 can be seen in Figure 4. The personal consumption expenditures (PCE) price index, which the Fed targets at 2 percent annual gains, rose 1.3 percent in January from a year earlier. That followed thirteen consecutive months with increases below 1 percent, mainly due to lower energy prices.

Figure 4



In mid-March, the Federal Reserve kept the target range for the benchmark federal funds rate unchanged at 0.25 percent to 0.50 percent. The main news in the Federal Open Market Committee's (FOMC) statement was that the median of policy makers' updated quarterly projections saw the fed funds rate at 0.875 percent at the end of 2016. That implies just two quarter-point increases this year, down from the four forecasted back in December. Weaker global growth has muddled the U.S. outlook and led many investors to expect a slower pace of tightening since the Fed raised rates last December for the first time in almost a decade. In its statement, the Fed said that investments by businesses and exports "*have been soft*" and that "*global economic and financial developments continue to pose risks.*" Furthermore, the Fed cut its forecasts of GDP growth in 2016 to 2.2 percent, down from a 2.4 percent forecast made in December. In late March, in a speech in New York, Fed Chair Janet Yellen said given the risks to the outlook, she considers it appropriate for the Fed to proceed cautiously in adjusting policy. Yellen said the risks of raising rates too soon and derailing growth outweigh the hazards of the Fed needing to catch up to a stronger-than-expected economy, largely because policymakers have fewer weapons to jolt the economy with its benchmark rate still near zero. Yellen described economic reports so far in 2016 as "*somewhat mixed*", noting that strength in the domestic labor market, consumer spending and housing had partially offset a sluggish global economy and low oil prices, which have hurt manufacturers' exports and business investment. Over the last few years, America's economic prospects have lagged even the most pessimistic predictions. In 2011, the Federal Reserve predicted that U.S. real GDP would, at worst, grow by 3.5% in 2013 and that the economy would expand between 2.5% and 2.8% annually in the long run. In every year since, the Fed has revised its predictions downward. The most recent estimate **predicts 2% growth in the long run – a rate more than one-third lower than the post-war average.**