



It's Different This Time

This phrase is often described as containing the four most dangerous words in the financial world because they are used to justify what frequently turn out to be poor investment decisions. But, this time, something really is different, and that is the phenomenon of negative interest rates. As of mid-June, government bonds in fourteen countries carry negative interest rates, and in three countries, Switzerland, Germany, and Japan, rates are negative as far out as the ten year maturity. Believe it or not, the interest rate on the thirty year Swiss Government bond just turned negative! And, in Denmark, it has been reported that some banks are paying people to take out mortgages; imagine that! The notion of negative interest rates is very difficult for even seasoned investment professionals to comprehend, and we certainly don't claim to understand all (or perhaps many) of their implications. But, for whatever it is worth, here is our take on some of what may be going on.



BY BILL SPITZ
Director

AS OF MID-JUNE, GOVERNMENT BONDS IN FOURTEEN COUNTRIES CARRY NEGATIVE INTEREST RATES, AND IN THREE COUNTRIES, SWITZERLAND, GERMANY, AND JAPAN, RATES ARE NEGATIVE AS FAR OUT AS THE TEN YEAR MATURITY.

continued on next page >

What Is Causing Negative Interest Rates?

First, governments around the world have responded to a low growth, low inflation environment with programs known as “Quantitative Easing” which entail the purchase by central banks of various types of bonds. The objective was to lower interest rates which was expected to stimulate economic growth by increasing borrowing which would in turn increase consumption and capital investment. These and other programs may well have saved us from a catastrophe during the global financial crisis, but they have not really achieved the objectives of moderate growth and inflation. For the past five years, real GDP growth in the US has been 2.1% versus a longer term average of 3.2% and inflation has averaged 1.3% versus the FED’s stated target of 2%. A more critical view of these programs is not only have they failed to achieve their objectives, but have distorted the capital markets by funneling dollars into stocks and bonds which has primarily benefited the 1% who own most financial assets. Regardless of your view on the wisdom of these programs, one lesson is that monetary policy by itself does not seem to be able to overcome the drag on economic growth created by low population and productivity growth.

The second key factor has been a flight to the perceived quality and safety of government bonds by investors concerned about a variety of issues including potential deflation, weakness in commodity prices, the possibility of Brexit, political turmoil throughout the world, and so on. This demand for government bonds has pushed prices to record highs and interest rates to all-time lows.

continued on next page >

Yield on German 10-Year Bond



IMPORTANT NOTES AND DISCLOSURES

This White Paper is being made available for educational purposes only and should not be used for any other purpose. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Diversified Trust Company, Inc. believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.

Opinions expressed in these materials are current only as of the date appearing herein and are subject to change without notice. The information herein is presented for illustration and discussion purposes only and is not intended to be, nor should it be construed as, investment advice or an offer to sell, or a solicitation of an offer to buy securities of any type of description. Nothing in these materials is intended to be tax or legal advice, and clients are urged to consult with their own legal advisors in this regard.

A chart of the 10 year US Treasury interest rate follows the same basic pattern with the exception that its yield is currently 1.6%.

That raises an interesting question-will negative interest rates come to the US? Of course, anything can happen, but we think it unlikely. First, the US economy is stronger than many other industrialized countries and there are some early signs of rising wages which may finally result in inflation approaching the FED's target of 2%. Second, the FED has expressed its intention to raise interest rates over the coming year although they have pushed out the timetable several times due to lackluster economic statistics. If in fact interest rates in the US continue to exceed those in the rest of the industrialized world, this may place upward pressure on the Dollar which would likely hamper exports and restrain already moderate economic growth. So, while we don't expect negative interest rates in the US, we think we could be in a sustained period of low rates which has negative implications for many types of investors; particularly insurance companies and pension funds.

continued on next page >

Our Investment Strategy

Very low or negative interest rates are telling us that we are likely to remain for some time in an environment characterized by low economic growth, low inflation or even deflation, disappointing corporate profits (we have experienced five consecutive quarters of declining S&P 500 profits), and the risk of negative shocks, particularly those associated with the late stages of the credit cycle. While we don't foresee a financial crisis, this scenario likely translates into modest returns on most investment categories. The best predictor of bond returns is today's interest rate which is approximately 2.4% for a blend of Treasury and corporate issues. We monitor several firms that have good track records forecasting stock returns and their current predictions for US stocks range from 0- 3% per annum over the next seven to ten years. Their forecasts for non-US stocks range from 4-10%.

Our own views as well as these forecasts lead us to our current investment strategy which can be summarized in the following bullet points:

- **Underweight fixed income due to low prospective returns.**
- **Maintain target equity exposure with particular emphasis on private equity and equity real estate. Maintain significant exposure to non-US equities due to attractive relative valuations.**
- **Emphasize investment strategies whose returns are independent of, and not correlated with, those of stocks and bonds.**

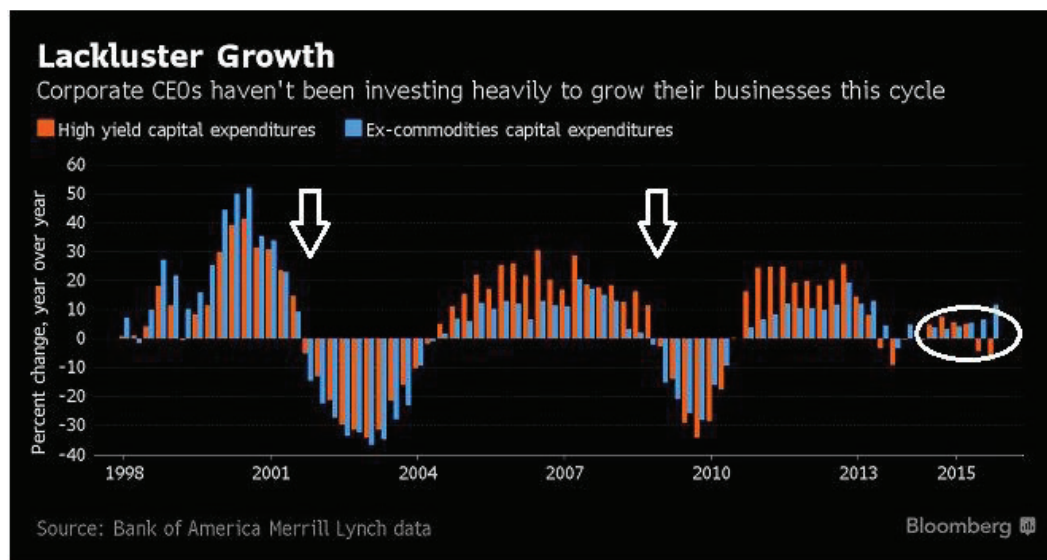
We also recommend that all investors carefully evaluate their spending rate in light of the prospects for single digit portfolio returns.

continued on next page >

Really Big Questions

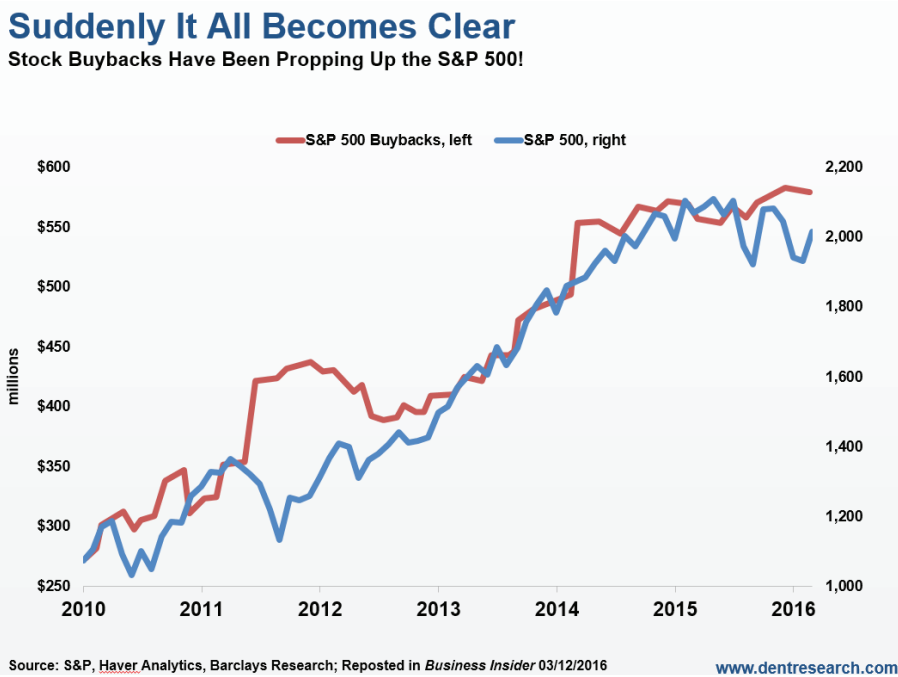
Negative interest rates raise a number of fascinating questions regarding the likely behavior of individuals, corporations, governments, and so on. For example, will individuals choose to raise or lower the percentage of their income they choose to save? On the one hand, zero or negative interest rates might induce people to consume rather than save. On the other hand, if negative rates are caused by deflation, the act of saving actually results in an increase in purchasing power even without receiving any interest. To the extent that individuals do save, will they pull money out of banks and money market funds in favor of stashing piles of cash in safe deposit boxes? Banks make their money by lending at a higher rate than their cost of funds. In a world of negative interest rates, is this model viable?

As previously stated, one of the objectives of central banks was to induce corporations to borrow in order to finance capital expenditures which would in turn stimulate the economy. In fact, debt issuance is at record levels and has risen almost 70% over the past five years. But, as depicted in the following chart, capital expenditures have been quite modest in comparison to prior economic recoveries.



So, what are they doing with the proceeds of bonds issued? The answer is stock buybacks which have clearly played a significant role in the bull market since 2009.

continued on next page >



This raises a number of interesting questions. How will equity markets behave if they lose the support of stock buybacks? Are corporations damaging their future competitiveness by buying their stock rather than investing in their businesses? And, has the use of debt and retirement of equity resulted in undue leverage on corporate balance sheets?

There is the interesting question of how (or whether) central banks will unwind their quantitative easing programs. Given modest economic growth, can central banks terminate them which would likely cause rates to rise? Who will refinance the debt sitting on their balance sheets as it matures?

In finance 101, you learn that the value of any asset (stocks, bonds, real estate, etc.) is equal to the present value of the cash flows that you will receive by virtue of owning that asset. And, the cash flows are discounted at a rate that is based on the yield of the US Treasury Bond. So, in a world of negative interest rates, financial analysis is turned upside down and it is difficult to figure out how to value any security.

Finally, there is the question of whether nervous investors seeking a safe haven have actually increased their risk by filling their portfolios with bonds in which prices have been bid up to unsustainable levels.

continued on next page >

Conclusion

It's rarely "different this time" but we are currently experiencing an economic environment that has never been seen by investors. It is both fascinating and somewhat scary given all of the unknowns. In the final analysis, we are likely to muddle through with modest returns and a good deal of volatility and our investment strategy is designed to deal with these realities. It is somewhat hackneyed, but the ancient Chinese curse "May you live in interesting times" certainly applies. ■

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333



GREENSBORO

300 N Greene Street, Suite 2150
Greensboro, NC 27401
Phone: 336.217.0151



MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979



NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302