Review & Outlook

THIRD QUARTER 2016

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Review

The S&P 500 index moved in a fairly tight range during the third quarter of 2016, reaching a new high of 2190 in mid-August. It ended the quarter at 2168, a total return up 3.85% since June 30th.

For most of the quarter, the 10-year treasury rate has been grinding higher from the early July low of 1.37%. It reached a quarter-high of 1.73% on September 13th, but dropped a bit when the Fed held rates steady.

Outlook

The US economy continues to grow slowly, with the Fed still not seeing enough positive news in labor and inflation data to initiate another interest rate hike. If the Fed does raise rates this December, it will be the only increase in 2016. In December 2015, they raised rates for the first time in many years, and expected to increase rates at least four times in 2016. The Fed's lack of action this year reveals that the economy has not been as healthy as predicted. Still, there is no compelling reason to think that we are about to hit a significant economic downturn. The National Association for Business Economics continues to forecast a 2016 annualized growth rate of 1.8%.

With the Fed on hold until December, investor anxiety will likely shift to the upcoming elections, at home and abroad, and we think that the upcoming US elections may be a source of market uncertainty that could create some volatility. But that volatility is likely to be transient, much like the outcome from the Brexit vote.

In Focus

Influential central banks such as the Bank of Japan, the Swiss National Bank, and the Deutsche Bundesbank currently have negative 10-year interest rates. Negative interest rates are unprecedented, and remain an experiment in progress. The hope is that negative interest rates will force people to find better places to put their money by investing it and/or buying things, thereby contributing to economic growth and inflation.

In the United States, the government 10-year rate is historically low, currently at about 1.6%, but seems a good deal compared to negative yields. As such, funds are flowing into US fixed income, bidding up bond prices and keeping downward pressure on US bond yields.

A difficult aspect of the low interest rate environment is that there is very little interest income flowing from high quality bonds. This hurts those depending on interest income; particularly retirees. In the United States, the impact is particularly acute as the first wave of the baby boomer generation starts to retire.

While focus has been on negative rates in the wake of the recent financial crisis, natural interest rates have been declining in major western economies since 1980 (see Figure 1[1]). The natural rate of interest is a theoretical construct specifying where growth and inflation are in balance, with two important implications. First, we can reasonably expect interest rates to remain lower for longer; and second, when the next economic downturn occurs, the Fed will have less room to use monetary policy to respond, as lowering the short-term interest rate is the Fed's main tool for fighting economic downturns.

The gathering consensus about the lower natural rate is fueling commentary that central banks and monetary policy are "losing their effectiveness", with recommendations that fiscal policy, or targeted government spending, play a larger role. Given the rather dysfunctional nature of the current government in many countries (the US being no exception), the need to rely on the craft and implementation of well-reasoned fiscal policy is not particularly reassuring.

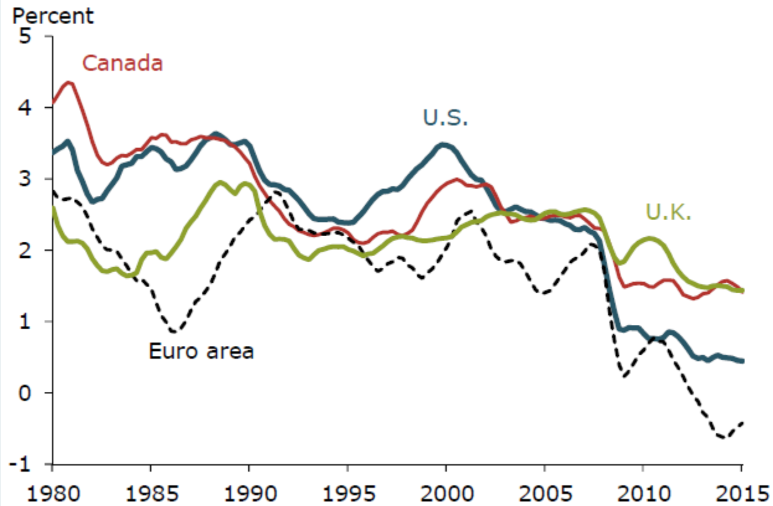
There are five factors behind the decline of natural rates that deserve attention:

1) Shifting demographics: Nearly every major economic power in the world has an aging population. As populations age, a smaller percentage of people are left in the workforce, overall consumption patterns change, tax

revenues decrease, and government expenditures increase for things like health care. It also affects the investment decisions of companies who might have less incentive to expand their business.

2) Unusually low productivity growth: At the simplest level, economic growth is largely driven by productivity growth and population growth. A lack of investment is often cited as a key problem. Some argue that the problem is really one of how we measure productivity. For example, it is difficult to measure the impact of technologies like Google Maps and innovations like Uber if the focus is on GDP.

Figure 1
Estimated inflation-adjusted natural rates of interest



Source: Holston, Laubach, and Williams (2016); data are four-quarter moving averages.

3) Wealthy investors from emerging markets seeking safe investments: A growing pool of very wealthy investors from China and other countries (often with a combination of weak financial markets, weak institutions, and high levels of corruption) are searching for safe assets. They tend to focus on assets denominated in dollars, but also euros and yen. By bidding up the price of bonds from desirable countries, they put downward pressure on the corresponding interest rates.

4) Fiscal tightening in order to cut deficits post-financial crisis: Most western economies ran large fiscal deficits through the recent financial crisis. Fiscal hawks are challenging any plans for fiscal stimulus and are, in general, spending less (or at least spending at diminishing rates). Efforts to control spending can slow growth and inflation, reducing upward pressure on interest rates.

5) A general global savings glut: Corporations, pension funds, sovereign wealth funds, and other groups have an unprecedented amount of cash that needs to be invested. The amount of cash may significantly outweigh investment opportunities, and the massive demand for quality financial capital, namely government bonds, creates additional downward pressure on interest rates.

The decline in the natural rate is causing investors to take greater risks to gain some kind of yield, with investors bidding up the price-earnings ratios of many stocks to historically high levels. Additionally, the high-yield debt market has been bought aggressively, further driving down yields, especially with respect to the underlying risks. Many companies in emerging markets have taken advantage of this demand, and have issued billions of dollars of junk debt in dollar or euro denominations. One reason that emerging markets start to slump with any hint of higher US interest rates is that it will likely push up the dollar and make these loans more difficult to service, increasing the likelihood of significant defaults.

There is no clear path out of this low interest rate environment. The demographics issue, in particular, will be an ongoing and increasing challenge. A reasonable way to proceed is to expect low interest rates for the foreseeable future. A main catalyst for increasing interest rates will likely be some kind of inflation (hopefully driven by growth rather than printing money). Equities, to the extent companies have hard assets and the ability to raise prices with inflation, should be able to compete well with bonds. If there is a view that bonds are about to start a long march higher (as opposed to a single, large jump), equities still might retain relative strength.

For Waycross clients, we continue to lean towards equities, and short maturities for bonds, with a "hold to maturity" strategy. We believe this a prudent balance of risks as we continue to navigate this low interest rate environment.

1. Williams, John C. "Monetary Policy in a Low R-Star World." *FRBSF Economic Letter* 2016-23 (15 Aug. 2016): 2. Print.