Real life requires active management. September 30,2019

E.Q Trendwatch™

Superbankers and the world of NIRP

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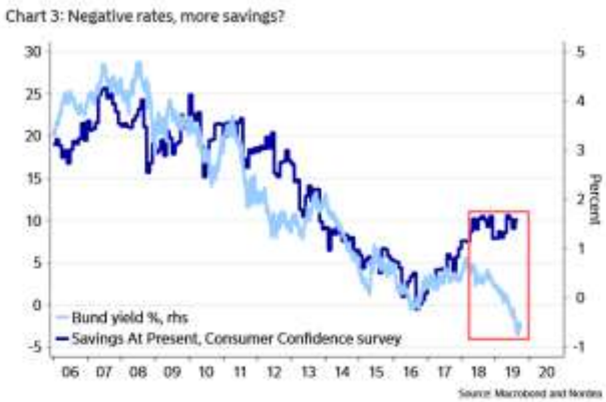
> *"The world changes! So, we're in a situation today where the only policymakers that have flexibility* are central banks. *But they don't have the instruments! They've had to experiment, and the more you experiment, the more uncertainty and the higher the risk of collateral damage."* – Mohamed El-Erian, economist

Year to date, central banks have announced 35 interest-rate cuts globally, even though savers, financial institutions and economies are already exhibiting destabilizing impacts from a decade of near zero (ZIRP) and now negative rate policies (NIRP). A sharp reversal from its hiking bias last December, the US Fed made a second rate cut to 1.75% in September. It's worth noting that initial Fed easing following a tightening cycle has generally occurred during or immediately preceding past recessions and bear markets (see chart page 8).

The European Central Bank (ECB) took its reference rate to -.50% and pledged to resume its bond-buying program (QE) in the amount of €20bn per month "*for as long as necessary*". The stated aim is to stimulate investment and spending by making it cheaper to borrow money. In practice, however, it is increasingly acknowledged that supressed interest rates are having the opposite effect and spending and economic growth are faring the worst in countries where NIRP has been implemented. A recent study notes:

> *"…following the introduction of negative interest rates, bank lending was weaker in countries that did not adopt the policy. This was largely driven by the compressed net interest margin from a long-term low yield...negative interest rates also appear to have cancelled out the stimulus impact of other forms of unconventional monetary policy such as quantitative easing."*

Shown below since 2006, as German interest rates fell from near five percent in 2008 to zero by 2016 (light blue line below), the level of consumer savings fell (dark blue). But since 2016, the opposite has been happening: saving levels have increased on NIRP and then ZIRP, thwarting central bank presumptions to the contrary.



Still, with monetary policy out of other ideas, markets are pricing in a further 58 rate cuts globally over the next 12 months. Presently, the U.S., UK, Canada, Australia and New Zealand are the only developed bond markets without negative yields. As we anticipated, this is driving money into North American bonds, pushing up the value of our existing holdings while lowering the yields available on new funds for investment.

Hard assets like gold and silver bullion have always been negative yielding after owners pay for insurance and storage. Real estate is often negative yielding when it does not generate income sufficient to pay for its carrying costs. Stocks and corporate bonds are always at risk of negative yields when their value can fall more than any income received in dividends and interest. However, cash equivalents and treasuries are supposed to be the only assets guaranteed to generate a contractually prescribed level of income and return of principal over the holding period.

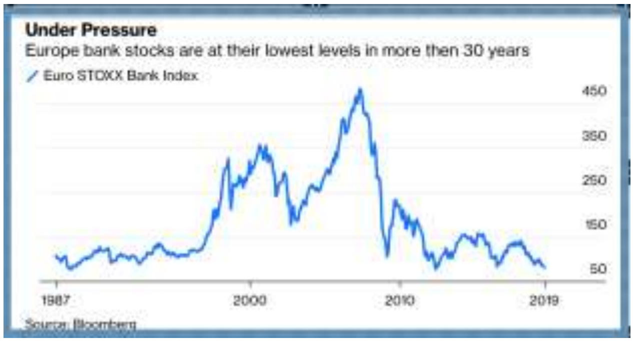
Negative rates on cash and treasuries distort the risk-free rate against which all capital markets are priced, and work to drive capital out of the banking system and into private vaults and less liquid alternatives. This reduces bread and butter 'spread' profits on which financial intermediaries depend, while lowering the amount of capital on which the banking system is levered. Joint research published last month by economists from the US Treasury Department and several universities found 'robust' evidence that bank lending and insurance underwriting were weaker in countries with negative rate policies.

While European banks have tried to offset negative spreads by increasing customer fees, this has been insufficient and prompting an exodus of customers moving to institutions who have not yet increased fees. As explained in *The fallacy of the natural rate of interest and zero lower bound economics (April 2019):*

> *"…a negative deposit rate is a form of tax on money that lowers real wealth, which lowers consumption and increases saving. If banks are charged negative rates on their central bank deposits, they will pass those charges on to consumers in the form of fees and negative deposit rates, and possibly even raise loan rates to recoup their costs."*

Danish central bank rates have been negative for seven years now and were recently cut to minus 0.75%. In response, Danish banks have attracted a surge in refinancing by offering mortgages with negative rates out to 10-years. But they also started charging -0.40% on customer deposits of $1 million+ and this month reduced that threshold to include accounts of $100k and more. (*See Negative rates just got real for a record number of bank clients*). Nevertheless, consumer deposits rose to a record 1 trillion kroner in July, up 14% since 2017.

Germany's finance Minister is now mulling the idea of banning banks from passing on the costs of negative rates to their customers, even as bank profits are weak and EU bank shares (left) are trading at their lowest level in over 30 years. The hoarding of cash reserves outside the ECB and bank accounts seems likely to continue. The amount of physical cash reported in vaults has leapt 57% since negative rates were introduced five years ago.



Historically, cash-piling has been a common response to lost faith in the banking system. Liaquat Ahmed's Pulitzer Prize winning book, *Lords of Finance: The Bankers who Broke the World (*2009) (which we highly recommend) describes similar behaviour in 1931 as rising withdrawals caused many banks to close:

> *The mounting bank failures intensified hoarding—$500 million in cash was pulled from [US] banks. While most of this was stashed away in traditional places—socks, desks, safes, strongboxes under the bed, deposit vaults—some found its way to very unconventional spots, including, according to a congressional report, 'holes in the ground, privies, linings in coats, horse collars, coal piles, hollow trees.' Anywhere, but bank accounts" (p. 435).*

Of course, the way fractional banking systems work, less cash on deposit means less credit on offer. And when outflows outpace inflows, a deleterious circle unfolds where banks call in existing lines of credit used by small businesses and households in order to shore up reserve ratios. This tends to intensify a liquidity crunch through the broader economy.

To the masses, central bankers are little known characters who mysteriously influence interest rates. Certainly, their injections of liquidity and lender of last resort actions have helped to quell some episodes of financial panic in the past 100 years. But somewhere between the end of Paul Volcker's head of the US central bank in August 1987, and the current board under Chairman Jerome Powell, efficacy has changed for the worse.

One catalyst, as we explained in July's letter, was the 1978 addition by the US Congress of "full employment" as a second mandate to the Fed's long-standing goal of 'price stability'. This seemed like a good idea to those seeking perpetual economic expansion but, in reality, the dual mandates are at odds: the full employment goal favours continually countering economic slow-down (regenerative episodes of debt reduction and savings rebuild) by encouraging more debt-fueled spending and lower savings rates, even as doing so eventually undermines the first mandate of price stability.

History attests that extended borrowing and spending cycles can drive debt and inflation higher until, finally, too much debt forces consumption lower, asset bubbles to burst, deflation, recession and sometimes depression.

By the time Volcker was appointed to chair the Fed in August 1979, the economy had been expanding for a longer-than-average nine years and was over-heating with double digit inflation. The solution devised was to hike rates enough to slow spending and break the runaway cost-of-living. The Fed ratcheted its policy rate from 11.2% in 1979 to 20% by June of 1981. Speaking on MacNeil-Lehrer News Hour in 1979, Chairman Volcker explained that notwithstanding recessionary pains, the longer-term monetary goal of price stability had to take precedence over the shorter-term goal of full employment:

> *"...this is the kind of circumstance which leads to concern about recession; and I share that concern. But…if inflation got out of hand, it's quite clear that that would be the greatest threat to the continuing growth of the economy, to the productivity of the economy, to the investment environment, and ultimately to employment…Now, I'm not saying unemployment will not rise. I am saying the greater threat over a period of time would come from failing to deal with inflation rather than efforts to deal with it."*

By July 1981, North America was working through a double-dip recession and Canada Savings Bonds were yielding savers an unprecedented 19½ percent—job loss, defaults and bankruptcies rose. Between 1980 and 1982, the Canadian stock market fell 44%, and real estate prices lost an average of 25% with greater than average losses in the western provinces. On the upside, the rate of inflation did tumble more than 50% from 14.76% in April of 1980 to 6.51% a year later. Finally, investment prospects were attractive once more and capital flows began multiplying through the economy.

Unlike the preoccupation of today's central banks, Volcker made no mention of the stock market in the Fed's policy decisions. The Fed knew its actions were likely to trigger a downturn but understood that doing so was necessary to restore longer-term financial stability. President Ronald Reagan replaced Chair Volcker with Alan Greenspan in August of 1987, just in time for a 22% collapse in the stock market in one day on October 19, 1987.

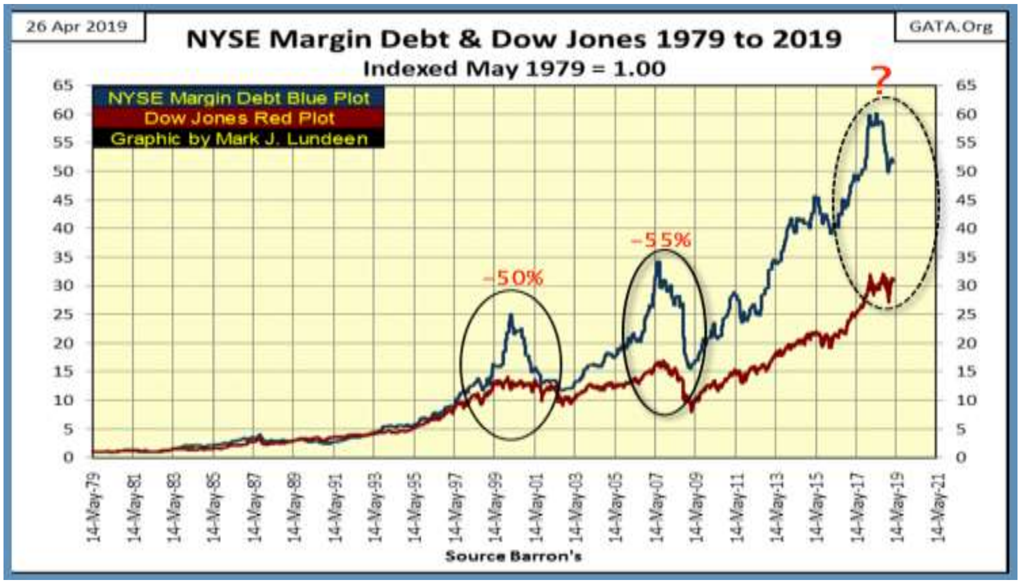
In truth, the drop in 1987 was well earned. The five years preceding had seen the Dow Jones Industrial Average more than triple on highly levered computerized trading. Nevertheless, Chair Greenspan surprised his fellow libertarian and free-market proponents alike with a bailout pledge that the Fed would "*serve as a source of liquidity to support the economic and financial system.*" Markets bounced, reclaiming their previous peak within eleven months.

From that point forward, whenever stock markets fell by 20% or more, the Greenspan Fed came to the rescue of animal spirits. Participants were emboldened that the 'Greenspan put' would bail them out from any losses. Moral hazard is defined as the willingness to increase one's exposure to risk when we feel insured or protected from negative outcomes. Just as studies show that seat belts and airbags have made modern drivers more aggressive, capital market participants have done likewise. Each five to six-year market cycle brought more leverage and even higher asset valuations, followed by sequentially greater losses.

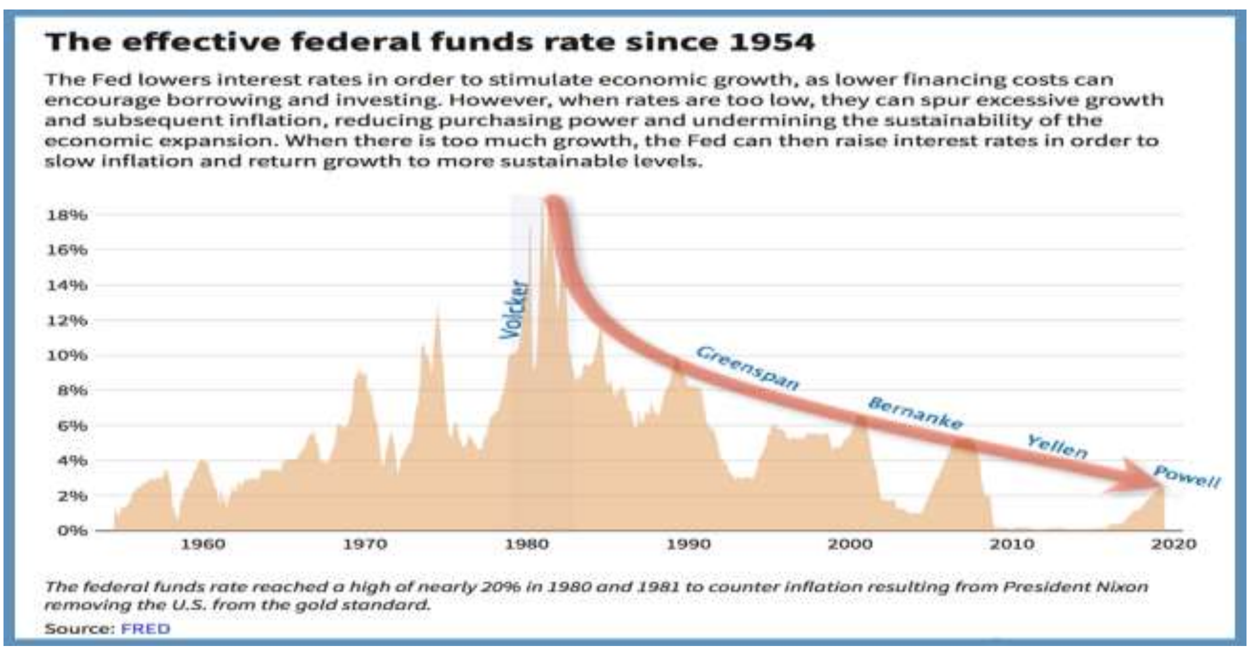
As pointed out by economist Dr. Lacy Hunt, central banks have always had the ability to greatly increase financial stability and reduce the incidence of panic and emergency intervention, if they would simply use their ability to limit margin loans at brokerage houses:

> *"The Fed was given control of margin lending in response to the excess speculation in the 1920's. When the bubble burst, a lot of small individuals were hurt, and the Fed was given that tool to use to prevent those types of situations from happening again."*

<u>Yet, the Fed has not stepped in to curtail margin lending since 1974.</u> Margin debt is shown below in blue with the Dow Jones stock average in red since 1979. The 2000 tech bubble/bust, 2006-07 housing and commodity bubble/bust and today's 'everything bubble' were all enabled by central bank failures to act as prudent financial regulators in favour of 'price stability', rather than speculation.



The chart below shows the effective US Fed funds rate since 1954, noting the Volcker-led hikes in 1979-80, and the miniscule monetary room that remains, after 40 years of slashing interest rates into each downturn.



Today's ZIRP and NIRP policies are a currency war in drag. When investment opportunities are weak and adequate return on capital improbable, banks have no incentive to lend and central banks are said to be "pushing on a string." Unproductive capital piles up, and growth and interest rates fall. Governments then look to devalue their currencies in the hope that cheaper exports may boost sales and offset domestic weakness.

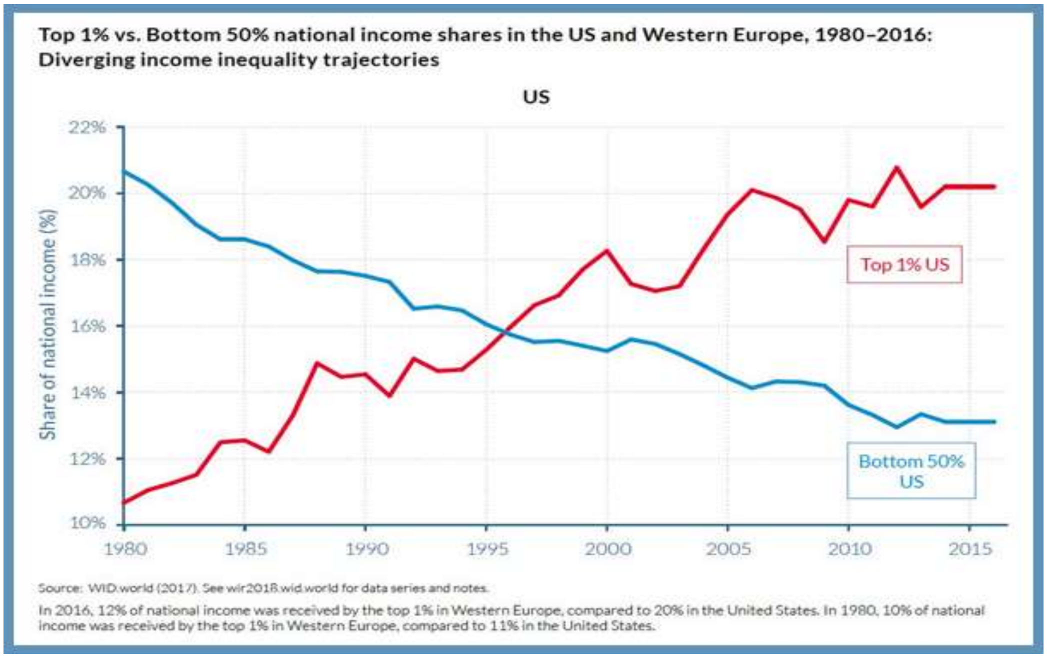
The global leaders in monetary easing, Europe and Japan—two of the world's largest economies— are now contracting. Export juggernaut Germany has been especially hard hit by shrinking demand for its automotive and manufacturing sectors. Escalating trade rhetoric and reciprocal tariffs are not helping. Analysts are now predicting that weak growth in the EU may yield eight more years of negative rates, and join central banks in urging (begging) governments to enact stimulative fiscal policies: *"Monetary policy may be able to prolong the current cycle, but ultimately we do not think it can prevent recession…eventually, this cycle will need to see a decisive shift from monetary to fiscal policy."*

The Trump administration's *Tax cuts and Jobs Act of 2017* was a fiscal stimulus effort, but ineffective because it focused on increasing cash in already cash-soaked multinational corporations. At the same time, tax cuts increased the budget deficit and US debt. This devalued the US dollar for a few months initially (black line shown below) before other governments and central banks devalued their currencies even more (other lines below since 2017).

There was talk that lost tax revenues would be offset by higher GDP thanks to stronger business investment and exports. That did not happen. Facing excess capacity in most sectors, corporations have little incentive for capital investment and have used extra tax savings largely to buy back their own shares, pay dividends and executive bonuses.

Nearly four decades of 'trickle down' experiments have run dry. With tax rates now near the low-end of historical ranges, wealth has increasingly pooled in a smaller and smaller percentage of the population. This has led to stockpiling, malinvestment and waste, but not wage growth or commensurate gains in productivity. In the meantime, deficits and debt have exploded and economic growth has stagnated.

The chart below, since 1980, shows the share of US national income for the bottom 50% (in blue) has fallen from over 20% in 1980 to 13% by 2016, while the share going to the top 1% of income earners (in red) nearly doubled to more than 20%.



International Monetary Fund studies show that globally this type of extreme income divergence has resulted in less prosperous economies and higher social instability, while increases to the bottom 20% have had positive, expansionary effects.

Progressively more lop-sided policies have run to a point of hard return. Getting more income to the bottom 50% while reducing expenses for the masses are now necessary to meaningfully improve prospects. History suggests that the process will not be quick nor painless for corporate profits, lenders and grossly inflated asset prices. On the other hand, history also attests that crisis is a necessary and powerful catalyst for fresh thinking and new ideas.

US and Canadian central banks are likely to cut bank rates toward zero in the months ahead. In September, Fed Chair Powell said he does not see the US going to negative rates, noting the undesirable impacts they are having in other countries. Hopefully, this rational observation holds, and the Bank of Canada follows suit.

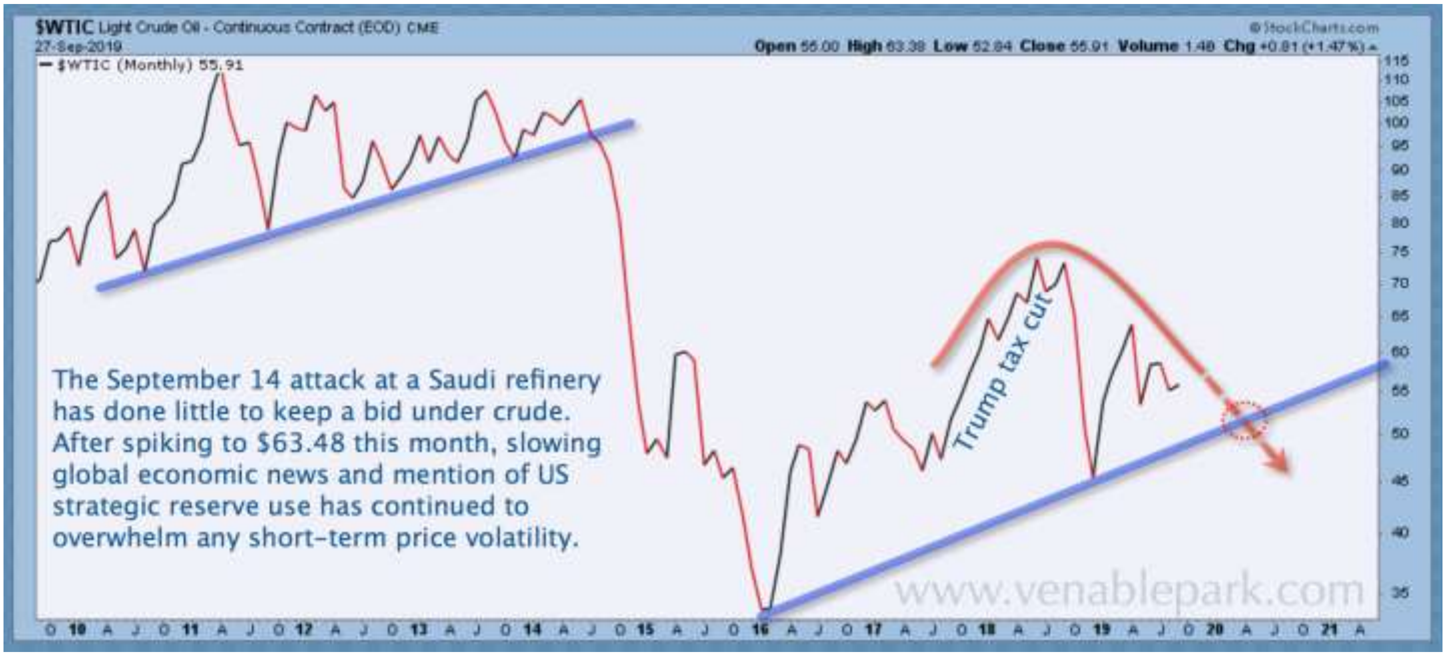
Either way, with debt maxed out, attentions must now focus on ways to improve household cash flow by lowering friction costs through technological improvement and investment in 'trickle up' areas likely to have the broadest benefit. These include retraining, education, more efficient food, energy, transportation and packaging, better water and air management, decarbonization and smarter buildings. The opportunities are both enormous and urgent. Following a financially destructive few decades, they remind us of what economist John Maynard Keynes said not long before his death in 1946:

"Economists are the trustees, not of civilization, but of the possibility of civilization."

As shown here since 1998, the start of Fed easing following tightening cycles has not been a bullish signal for stocks (S&P 500). Cutting cycles have generally occurred during or immediately preceding past recessions and bear markets. Though initial announcements often spur rallies, they then give way to the next sell-off.

The U$, here since 2000, has maintained a rising trend against the loonie since 2011. During periods of economic disappointment, the U$ typically strengthens against the C$ and emerging market currencies. The loonie bottomed with equity markets in 2002 and 2009 and we expect a similar pattern is likely to transpire in the months ahead, generating further capital gains in our accounts.

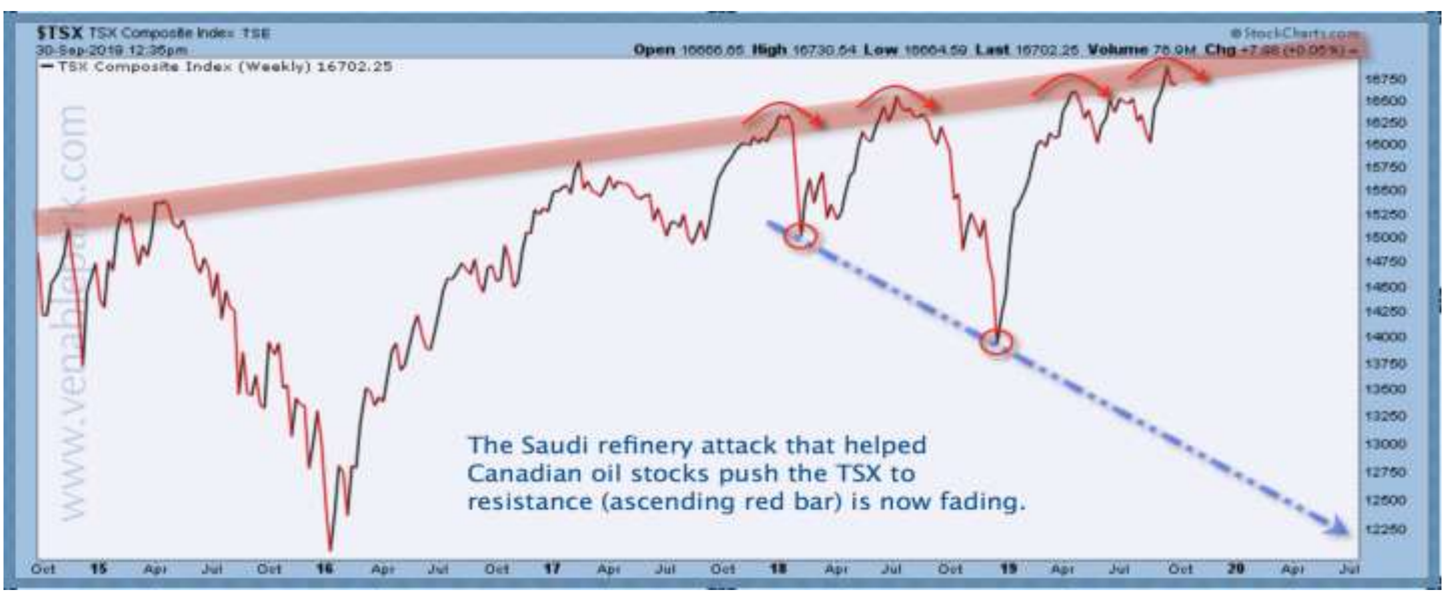
Oil (WTIC), here since October 2009. The downward price trend since 2008, 2011 and 2018 remains intact. Crude bottomed with the economy/market cycle in 2002 and 2009 and could potentially test the $25 area this cycle, with West Canadian Select (WCS) back in the low teens, well below the break-even point for producers.



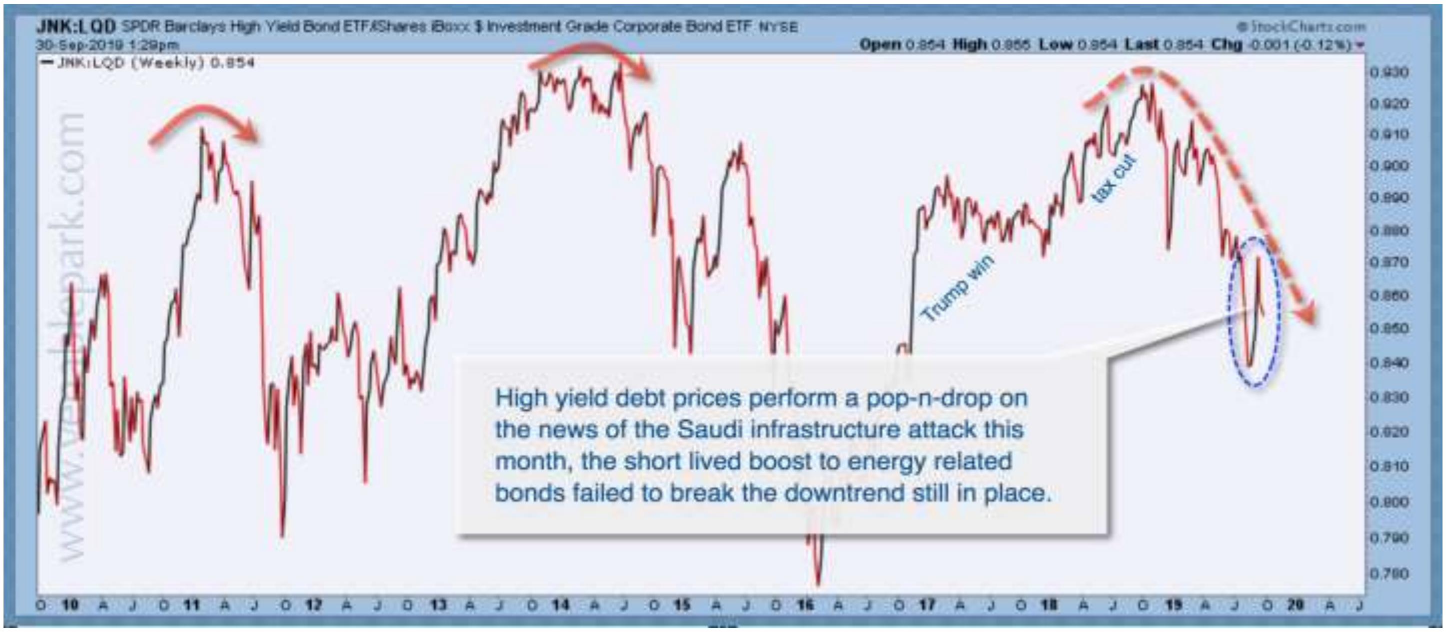
Shown quarterly here since 2010, the number of S&P 500 companies making new highs versus new lows fell 48% in September and has been making lower highs with each rally since 2013. This is a sign of weakness.

Despite corporate buybacks, the S&P 500 (below in red since 2014) has been stuck in a topping formation since September 2018. At the same time, the broader Russell 2000 index of smaller public companies (in blue) has not kept up and lost 12% over the past year. Trade wars sometimes boost the sales of smaller more domestic producers—that's not happening. This confirms economic weakness at home and abroad.

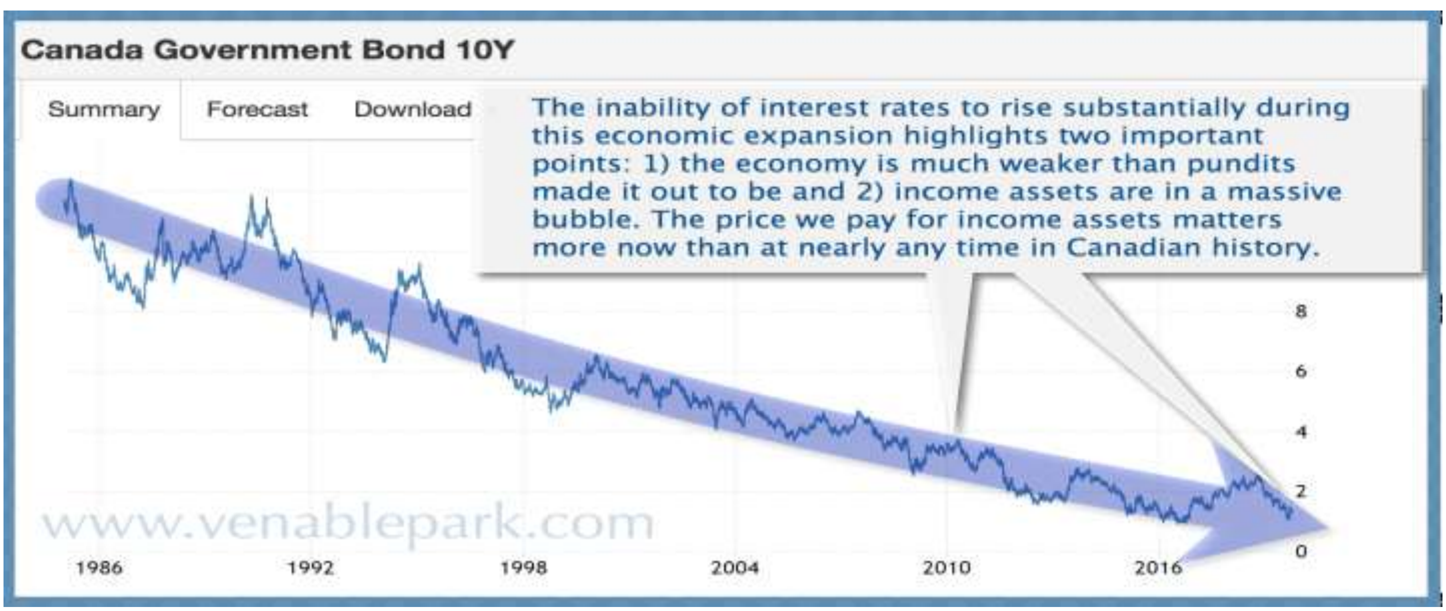
Canada's TSX index rallied with oil stocks on the Saudi refinery attack mid-month, before weakening into month end again. The next business cycle contraction will bring equity-based income assets much lower as present holders liquidate into capital losses. The larger the price decline, the higher the yields will be for bargain buyers, with less risk to capital and attractive value for those waiting to buy.



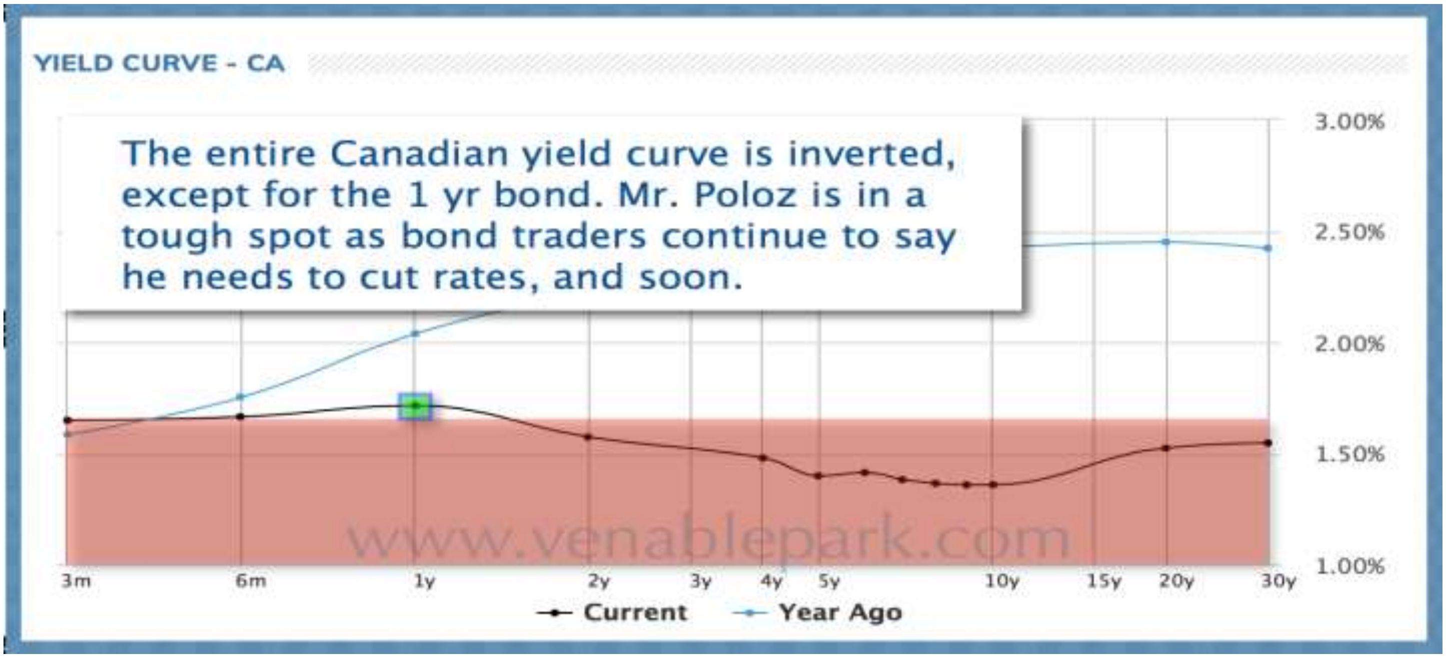
The lowest quality corporate 'junk' bonds have lost ground to the highest-grade issues since the fall of 2018 (ratio below since 2009). Capital continued to move out of junk debt into higher quality credits this month.



The downtrend in Canada's 10-Year Treasury yield has continued since 1982, including year to date. At just 1.37 today, a retest of the .96 low of July 2016 is probable and would cause our bond holdings to appreciate further. The Bank of Canada (BOC) is likely to follow the US Fed in cutting its policy rate back near zero in coming months as the economy weakens. Already highly indebted and under-saved however, households are likely to pay down debt and build up cash rather than borrow significantly more at this point in the cycle. Meanwhile, record-low interest rates have made dividend stocks the most over-valued in history.



Canadian treasury yields are now less than the 1.75% Bank of Canada (BOC) rate at every point out to 30 years and the yield curve is the most inverted since the 2008 recession. Although the BOC's growth forecast agrees with the bond market's forecast of economic weakness, the BOC has thus far held off cutting rates. With global exporters now suffering, they are likely to reluctantly return to rate cuts before too long.



US Treasury 10-year versus 3-month yield curve (here since 1990) re-steepened this month, after bottoming in August. A similar reversal marked the onset of the last two recessions in 2001 and 2007 (red arrows).

Happy Fall!

Quotes of the month:

"Eventually the policy of keeping U.S. interest rates low to shore up the international exchanges precipitated a bubble in the U.S stock market. By 1927, the Fed was thus torn between two conflicting objectives: to keep propping up Europe or to control speculation on Wall Street. It tried to do both and achieved neither.

…In the 1930's most depositors had to line up physically outside their bank to get their money. Now massive amounts of money are being siphoned off with the click of a mouse. Moreover, the world's financial system has become both larger compared to GDP and more complex and interconnected. There is much greater leverage, and many more banks rely on short-term wholesale sources of funding that can evaporate overnight. The world's banks are therefore much more vulnerable than they were then."

--Liaguat Ahamed, Lords of Finance: The Bankers who Broke the World (2009), p.499.

"While increasing risk-aversion at hyper-valued extremes typically results in spectacular market losses, the dispersion since early-2018 has been accompanied by a price-insensitive and backward-looking exodus of investors toward passive indexing, despite the highest valuations and weakest prospective market returns since the 1929 peak. Indeed, Morningstar reports that nearly half of all mutual fund assets are now passively managed, typically tied to capitalization-weighted indices like the S&P 500. All of this backward-looking performance chasing is likely to end badly, but over the short-run, it has been a thorn in the side of value investors…A passive investment strategy is now closer to "all risk and no reward" than at any moment in history outside of the 1929 market peak."

—John Hussman, economist August, 2019

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