April 2015

Negative Interest Rates

Alice in Wonderland

One of the things that makes investing so endlessly fascinating is that things you thought were impossible … actually happen.

Today's surprise is that interest rates on government bonds are now actually below zero in Germany, Sweden, Denmark, Finland, Netherlands, Austria, and Switzerland. And no small potatoes either: more than €1.5 trillion of euro area bonds maturing in a year or longer – almost 30% of all outstanding Eurozone sovereign debt[1] - are trading at yields below zero.

And not just short term bonds: Finland issued 5 year debt at negative yield in early February. Germany and Denmark's bonds are trading at negative yields out to 6 years, and Swiss 10-year debt is less than zero yield!

Negative yields are not just some trivial curiosity of the financial world. They represent a major distortion in capital markets. Negative interest rates mean that bond investors are willing to pay more today for a bond than they will receive in interest payments and principal when the bond matures. Even before inflation and taxes. If this sounds like a guaranteed loss, yes, it is.

Chris has a BA in Economics from UBC, and a business degree from Western (now Ivey MBA). Before joining Assante in 1992 he was Treasury Manager for a Fortune 50 firm where one of his responsibilities was Chair of the Investment Committee of the $65 million pension fund.

Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients.

For more information, please call (416) 216-6532 or email at choran@assante.com

[1] Financial Times, January 25, 2015.

Assante Capital Management Ltd.
130 Adelaide Street West
Suite #3401
Toronto, ON M5H 3P5

Phone: (416) 216-6532
Fax: (416) 216-6512
Email: choran@assante.com
Website: www.chrishoran.ca

Interest income, as any investment return, is supposed to be compensation for taking risk on an investment. A negative yield should seem like an Alice in Wonderland moment. It is.

It would be foolish to try and predict how something that has never happened before will progress, but it is highly unlikely that such an historical distortion can be unwound without serious repercussions.

The backdrop of low rates, as discussed in the previous newsletter, has been driven by central banks suppressing rates to stimulate economic growth and offset the contractionary effect of the financial crisis. These policies are reaching extremes never seen before: the European Central Bank (ECB) is the first central bank in the world to impose a negative interest rate policy by actually charging commercial banks to make deposits.

But why would investors buy an investment with a guaranteed negative return? There are several reasons for this apparently irrational behavior.

One is fear of deflation. If prices are going down, money becomes more valuable because it buys more things. (It's the opposite of inflation.) So if prices go down by more than you lose on a bond, you are ahead of the game.

A second reason is fear of damage to Eurozone banks from a Greek default and exit from the euro. Investors want to get their money out of banks and are willing to stuff it in a proverbial mattress.

But the strongest reason is the ECB is following the US Federal Reserve and printing money, called Quantitative Easing (QE). The ECB buys bonds with the newly printed money, which drives the price up and the interest rate down (they move in opposite directions). The newly printed money also depreciates the currency, which boosts exports.

Money is pouring out of the Eurozone and into Denmark, Norway, and Switzerland, which have their own currencies. Investors may feel it is better to lose a little on interest to avoid a bigger loss on the currency exchange rate. For instance, the Swiss franc appreciated by over 25% in the week when the Swiss abandoned its peg to the Euro.

The common denominator is fear. Fear of European banks, fear of exchange rates, fear of deflation, and fear of equity markets. To the value investor, where there is fear, there is opportunity. Fear and its compatriot, uncertainty, invariably lead to mispricing of securities. Being contrarian and taking advantage of uncertainty and fear is a cornerstone of the value investment philosophy.

Where is the opportunity from here?

First, a friend of mine once said, 'If something can't go on, it will stop. It's just a matter of being in control when it happens'. Negative interest rates may be explainable in terms of short term pressures and emotions, but they are an aberration that is not likely to go on for long. As I said, only a fool would try to predict the outcome, but …

Alice escaped the rabbit hole by waking from a dream. Bonds will not be so lucky. Central banks want inflation and they will print money until they get it. With inflation comes higher interest rates. Normal short term rates would be the GDP growth rate plus inflation.[2]

In order for interest rates to return to positive territory, bond prices must fall. It's a mathematical relationship: if the interest yield on a 10 year bond goes up by 1 percentage point, say from -0.5% to +0.5%, the price of that bond will fall by about 10%. Thirty year bonds are much more volatile (because the interest rate is locked in for so much longer): if the 30-year yield were to rise by 1 percentage point (as it did in 2013), the price of those bonds would fall by about 30%.

Canadian and US bonds are less extremely priced than Eurozones, but only slightly so. As a well-known bond manager said to me privately last autumn, the best case scenario for bonds over the next few years is that the price erosion caused by rate increases might be gradual enough to be offset by the interest coupon – in other words you might break even. That is a dismal prospect.

Investors desperate for income and terrified of equity markets have driven up the prices not only of bonds but all income securities. Thus the dismal prospects apply to any investment that has bond-like characteristics, i.e. anything that pays a fixed or stable income stream. The higher the quality of the income guarantee, the higher the price is today, and the greater risk of damage from rising rates.

The list, in descending order, is roughly like this: Government bonds, top-quality corporate bonds, lower quality corporates, income trusts, preferred shares, and other high-dividend payout, low growth businesses such as utility stocks.

Where is value?

If bonds and bond-like investments are overpriced, then value today is likely as far away from bonds as you can get. It may sound trite, or merely semantic, but it isn't. Sometimes the investment opportunity is illuminated by seeing where <u>not</u> to go.

That means today the opportunity is in common stocks – shares of well-run companies that pay dividends and have prospects for growth. Common shares are as far as you can get from bonds. Common stocks have no guaranteed redemption of your money (like the maturity date on a bond), they have no obligation to pay dividends (the way bonds are obliged to pay interest), and they have no collateral claim on a company's assets.

But the common shareholders own the growth. After the bondholders have received their interest and principal back, the growth in equity over time accrues 100% to the common shareholder.

The investment world has completely turned from 15 years ago. If bonds are usually safe, and today they are not, as Eric Bushell said to me last year, then it may be 'that safety today is where safety usually isn't, and danger today is where safety usually is'. In a turn worthy of Lewis Carroll, what was safe is now dangerous, and what was dangerous is now safe.

It is a most delicious irony, but no coincidence, that today 4 of the top 10 holdings of the CI American Value Fund, one of the largest holdings of many of your portfolios, are technology stocks: Apple, Oracle, Microsoft, and Texas Instruments.[3]

You will recall that in 1999, the manager, Bill Priest, wasn't within a barge pole of one single tech stock; yesterday's danger is today's value.

[2] GDP growth at say 2% and inflation at 2% implies short rates at 4%. The normal term structure of interest rates implies 5 year rates at least 4.5%

[3] Holdings as at December 2014. The manager in 1999 might have been Tom Sassi, if memory serves, since retired, but the message stands.

Common stocks represent far better value than bonds: the earnings yield on the S&P500 is over 6%[4] - more than 4 times the 1.5% on a 10-year bond. Nick Murray has been shouting from the rooftops that this difference has not been so great in our lifetimes.

Not only is the earnings on equities 4 times that of bonds, but those earnings tend to go up over time, where interest on a bond is fixed for the life of the bond (that's why it's called fixed income). Over the last 20 years, S&P500 operating earnings have grown at about 6% per year[5]. That includes the destruction of the tech crash and the 08 crisis.

Meanwhile, dividends – the portion of income that is paid out to shareholders – have been growing by double digits. According to Fidelity Investments global chief investment strategist Dominic Rossi, 9 of 10 sectors in the S&P500 have increased dividends in the last 12 months; 6 of these by more than 10%, and dividend growth overall is likely to continue at double digits as banks offset the oil companies.

If the math on bonds is dismal, here's Rossi's math on equities: S&P 500 dividend growth at only 8% puts dividends at $60 by the end of the decade. A 2% dividend yield, the average of the last 10 years, puts the S&P at 3000. From today's 2050 that's up almost 50%.[6] If dividends grow at the recent 10% rate, then 3500 is within reach by the end of the decade. That's the opportunity.

Warning

This is NOT to say that equities are safe. Just because bonds have poor prospects, and just because stocks represent decent and growing value, doesn't mean stocks are any less volatile in the short term. Stocks are as dangerous – in the short term – as ever.

It is over the longer term, say 3 – 5 years and longer, where the compounding of the 6% equity earnings is magnified by the growth in those earnings, that the value in equities will be realized.

---

[4] Earnings yield is just the inverse of the Price/Earnings ratio of about 17.

[5] S&P500 operating earnings, 1995 – 2014 growth rate est 5.9%: Bank Credit Analyst, December 2014 p33

[6] Fidelity Investments, D Rossi, Financial Times, Feb 5, 2015.

© 2015 Christopher Horan, all rights reserved.

This material is provided for general information and is not to be construed as an offer or solicitation for the sale or purchase of securities mentioned herein. Every effort has been made to compile this material from reliable sources however no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please make sure to see me for individual financial advice based on your personal circumstances. Neither Assante Capital Management Ltd. nor any of its affiliates accepts any liability whatsoever for any loss arising out of this report's contents. The opinions expressed are mine and not necessarily those of Assante Capital Management Ltd. Commissions, trailing commissions, management fees, and expenses may all be associated with mutual fund investments. The indicated rates of return are the historical annual compounded total returns including changes in unit/share value and reinvestment of all distributions/dividends. They do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Please read the prospectus and consult me before investing. Assante Capital Management Ltd. is a member of the Canadian Investor Protection Fund and is registered with the Investment Industry Regulatory Organization of Canada.

Assante is an indirect, wholly-owned subsidiary of CI Financial Corp. ("CI"). The principal business of CI is the management, marketing, distribution and administration of mutual funds, segregated funds and other fee-earning investment products for Canadian investors through its wholly-owned subsidiary CI Investments Inc. If you invest in CI products, CI will, through its ownership of subsidiaries, earn ongoing asset management fees in accordance with applicable prospectus or other offering documents.