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October 2020

Less Than Zero

"Maybe someday, saved by zero, I'll be more together. Stretched by fewer thoughts that leave me. Chasing after my dreams, disown me, loaded with danger. So maybe I'll win, saved by zero. Maybe I'll win, saved by zero – The Fixx

As of July of this year, the total value of government bonds trading at negative interest rates was $15 Trillion. That's down from the record $17 Trillion set in 2019, but certainly nothing to celebrate. That's about one quarter of all government bonds.

As illogical as it sounds, bonds purchased carrying a negative interest rate will pay back the buyer (lender) less than they paid for the bond in the first place. Why would anyone in their right mind do something as silly as this? I'll give you four reasons:

Safety. In times of uncertainty, investors flock to those investments considered "risk free". Government bonds are considered in this category (although I'm not sure that Greece would meet this test).

Deflation Fears. If it is anticipated that prices paid for goods and services will decline in the future, even faster than the loss on the investment, investors come out ahead.

Speculation. If interest rates are driven even lower than when the bond was purchased, the bond will increase in value giving the investor a gain in value of the bond.

Regulatory Requirements. Some institutions (banks) are required to hold government securities and have to accept the loss of principal as a cost of doing business.

Now, if you look at that list and think to yourself, that doesn't sound like an optimistic view of the world, you'd be right. Negative rates exist when investors (people) are concerned about the future (hard to imagine, I know).

Here in the US, our intrepid (sarcasm intended) Federal Reserve has brushed off the notion of negative rates. According to Jerome Powell, in testimony given before Congress in November of 2019 - "Negative interest rates would certainly not be appropriate in the current environment. Our economy is in a strong position. We have growth, we have a strong consumer sector, we have inflation...You tend to see negative rates in the larger economies at times when growth is quite low and inflation is quite low. That's just not the case here." What a difference a virus makes.

Although so far we (Ok, the Fed) have resisted the temptation to take US government bond yields to negative territory, here is a brief history of US treasury yields since 1962.

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As you can see from the graph on the previous page, the peak of the ten-year US treasury yield, back in the early 1980's, was 16%. The current yield (October 1st) on the same US government bond is .68% (maybe the applause for the Fed was a bit premature).

Granted, back in the early 1980's inflation, as measured by the Consumer Price Index, was running at about 13.5%. Today that same measure (and by same, I mean completely different measure – more on that in a later piece) is at .62%. So, back in the '80's you could earn a real 2.5% (16% return - 13.5% inflation) while today that amount is zero. And when you consider how the US government games the inflation number, by excluding food and fuel, and under-allocates the amount for healthcare expense (who needs to buy these things anyway) the real return is certainly much less than zero.

All of this interest rate insanity was designed to spur borrowing and lending. The theory goes as follows: if we (the Fed) take away any potential earnings on safe investments, you (the marks) will be inclined to borrow funds and invest in higher return ventures like stocks, real estate, a business venture, etc. The problem is that nobody at the Fed bothered to check in with the lenders (banks). The Federal Reserve does not make loans directly to the consumer (yet), but relies on banks to get that money out and into the economy for productive projects. For every dollar of deposits, a bank can lend out ten. However, most bankers are rational human beings. They are looking at the current state of economic affairs and thinking to themselves why lend to someone who may be out of a job, or out of business in a couple of months? A completely rational thought. So, for now, money is not entering the economy in a meaningful way via this path.

Unfortunately for us, our friends at the Fed aren't bothered by the fact that very little of what they have tried to accomplish by driving interest rates to the floor has actually worked. Economic activity has ground to a halt – even before C-19 came onto our shores. It is their belief that they really just need to do more, even though the evidence is quite clear that they are pushing on a string. Don't let facts get in the way of a good theory.

At the same time that economic activity has stalled, our national debt has soared. Last year, the Congressional Budget Office (CBO) estimated that the U.S. federal debt held by the public would reach 98.2% of GDP, or $20.3 trillion, by the end of 2020. Now twenty trillion is not exactly chump change, but the more concerning number is the debt relative to our Gross Domestic Product (the measure of total economic activity in the United States). That estimate from the CBO was before the virus. The new estimate is that debt to GDP will hit 140% by year-end. The only time we came even close to this ratio was after two World Wars - at 118% of GDP.

Now there are a number of ways to get ourselves out from under this debt morass: default, defund, delay, or debase. The first, default, is economic suicide. Yes, that would get us out from under the pile, but our days of floating treasuries to fund our profligate spending habits would be over – and nobody in Washington DC wants to see that happen. On the second, defund, see the first. Congresspeople are loath to give up on their favorite spending projects. The third, delay, is to follow the path of Austria. In 2017 they issued the first 100-year bond (paying a whopping 2.1%). This is really more a disguised default, as who is going to be around to collect? The final, and most probable, is to debase the currency. In simple terms that means to print more dollars (check). By putting more dollars in circulation relative to other currencies, our dollars are worth less. This spurs inflation (it takes more dollars to buy the same amount of stuff), and as a debtor nation we get to pay back our debts with money that is less valuable with each passing year. If you are in debt, inflation is your friend. Not so much if you're the lender.

There are a few potential snags to this strategy. First, you've got to get the money into the economy (I have a funny feeling the Fed is already working on an alternative path). Second, you don't want inflation to run too hot or you'll create tremendous civil unrest (like we need more). And finally, other countries are not going to sit by idly and watch this happen. Those that can print more currency will do the same, and voila, a currency war breaks out.

While we do not see wholesale inflation on the immediate horizon, we believe that it is inevitable. Of course, it is already happening in the aforementioned areas of healthcare, food and fuel.

In an inflationary environment you want to own things like stocks, real estate, energy and precious metals. In deflationary periods, bonds and cash. While we think that inflation is in our future, we have learned that thinking yourself smarter than the markets is a fool's errand. To that end we remain well diversified for whatever is to come.

As always, I wish you happiness and health. Take time to appreciate the vast number of good things in your life.

Those certainly add up to much more than zero.