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# Central Bankers Accentuating the *Negative*

**Y**ou may have heard the recent talk about *negative interest rates* and wondered what the world is coming to. Will banks and credit card companies soon be paying *you* interest on your outstanding debts?

Don't hold your breath, but several countries' central bankers, including Japan, Sweden, Switzerland, Denmark, and the euro zone, have decided that historically low interest rates just weren't low enough. They've gone negative, meaning that instead of their banks paying interest *to* depositors, they're charging them to safe-keep the money.

In the face of anemic economic performance and deflation fears, the objective is to further incentivize banks to write more loans at attractive rates, reduce the benefit of holding excess reserves, and boost loan-related income. Negative short rates also lessen the appeal of a nation's currency which can help its exporters. And if investors are induced to step even farther out on the risk continuum, it can help support equity and bond prices.

All *other* things being equal, it sounds like a strategy. But those other things move too, and there's plenty of potential for unintended effects. Rates have been so low for so long that it's hard to see why nudging them into the red would suddenly ignite loan demand. Weak economic prospects appear to be a bigger factor suppressing loan demand and widening credit spreads.

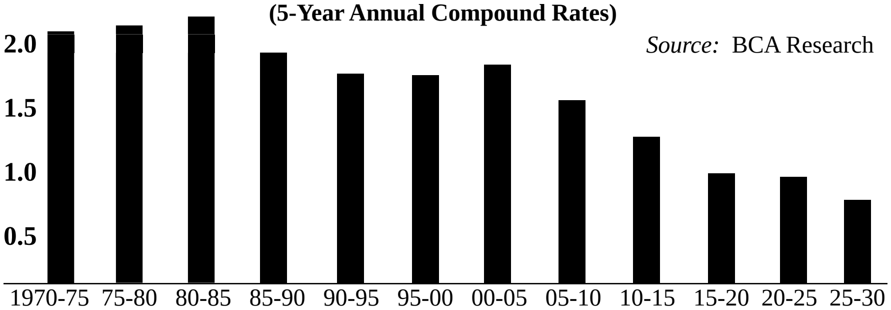
Even if negative short rates *can* push bond buyers out on the yield curve, that might just flatten rather than steepen the slope, defeating the desired boost to bank profits. And currency-related effects on exports can be short-lived if competing countries decide to play the same monetary card.

In theory, interest rates (the price of money) should help rationalize the allocation of capital. Some economists contend that the long run of near-zero rates has fed a fair measure of *misallocation*. A lot of corporate borrowing has been used for financial restructuring, mergers, and acquisitions rather than to expand and modernize productive capacity. Perhaps not surprisingly, nonfarm business productivity grew at an annual rate of just 1.2% for 2007 through 2015, matching 1973-79 for the weakest multi-year performance of the past 70 years.

Other powerful forces are at work. The economists at BCA Research point to one of them below: a pronounced, secular slowing in the *growth* of the world's working age population. The trend tracks from the opening years of the new century and appears to be baked in for at least the next two decades. Older households' tend to spend less and save more, which aligns with the theme of slack global demand. Prices for many goods are soft, and commodities are *way* down.

All that said, monetary policy remains the handiest weapon for the world's central bankers. It may seem that by now that all creditable borrowers have had ample opportunity to finance their dreams and schemes at very friendly rates. We'll see whether promoting even *more* debt can help somehow. ■

**Slowing Growth of the *World's* Working Age Population**
**(5-Year Annual Compound Rates)**




# Surprised? Really?

**T**his year started with a global pullback from risk assets. In other words, financial markets saw a lot of selling. Investors were said to be *surprised* by emerging economic challenges crystallized by the salient signal of collapsing oil prices. It was a ready explanation for a supposedly surprising investor reaction to supposedly surprising realities.

Then again, we know that markets cycle and sell off from time to time. We know that economic activity ebbs and flows; that industries go through periods of over-investment leading to excess production followed by contraction and contrition, setting the stage for more prudent capital allocation and better results down the road. Lenders and borrowers will be caught up in the process, magnifying those excesses on the way up as well as the dislocation and difficulties of the downturn.

Yet investors are described as being surprised when things that everyone knows will occur at some point actually do occur. We claim it's the *timing* of events that catches us off guard, although we know that nobody can consistently time the duration of such trends, and especially

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# High Yield Bonds Taking Their Lumps

It's been about five years since we touched on high-yield (lower-rated) corporate bonds. For most of that stretch it has been a reasonably rewarding sector, but not recently.

The average high yield bond mutual fund suffered declines similar to large cap stocks this past year. On the other hand, those high yield portfolios did average a respectable 5.3% annual total return for the past *10 years*, a period that included not only the recent weakness but also 2008's harrowing plunge (−26.4%).

A growing list of credit-rating downgrades has focused on the energy sector. As noted in recent *Quarterly* issues, the U.S. renaissance in energy exploration and development involved plenty of borrowed money. Some of the resulting production surge is clearly profitability-challenged at current oil process. Most of those companies' bonds have already been heavily discounted.

Corporate bankruptcy expert and New York University finance professor Edward Altman issues the Altman Annual Default Rate. Even with the uptick over the past two years, a default rate of less than 3% doesn't seem like much. But an uptick in defaults tends to affect the market value of *most* lower-rated debt, not just the bonds in default.

### Corporate Defaults Tick Up

| Year Ended | Altman Default % |
|---|---|
| 2015 | 2.83% |
| 2014 | 2.11% |
| 2013 | 1.04% |
| 2012 | 1.62% |
| 2011 | 1.32% |
| 2010 | 1.13% |
| 2009 | 10.74% |
| 2008 | 4.60% |
| 2007 | 0.51% |
| 2006 | 0.76% |

*Source:* Federated Investors

That's where selectivity and diversification come in. The high yield experts at Federated Investors expect a default rate in the 3.5% to 5.0% range this year. Headline risk related to bankruptcies and a tepid economy may continue to pressure prices from time to time. But in a yield-starved world, the sector could find favor and lead equities higher. It wouldn't be the first time. ■

| Investment Performance Review | TOTAL RETURN * (dividends and capital gains reinvested) | | | |
|---|---|---|---|---|
| **Selected Mutual Fund Categories *** | **--- Annualized through Mar. 4, 2016 ---** | | | |
| | ***1 yr.*** | ***3 yr.*** | ***5 yr.*** | ***10 yr.*** |
| Large-Cap Stocks (Blend) | − 5.8 % | 9.7 % | 9.1 % | 5.8 % |
| Mid-cap Stocks (Blend) | − 9.0 | 8.2 | 7.5 | 5.8 |
| Small-cap Stocks (Blend) † | − 9.5 | 6.7 | 6.5 | 5.2 |
| Foreign Stocks (Large Blend) † | − 10.3 | 1.3 | 0.9 | 1.7 |
| Diversified Emerging Markets † | − 16.0 | − 6.0 | − 4.2 | 2.0 |
| Specialty Natural Resources † | − 22.0 | − 8.6 | − 7.8 | − 0.9 |
| Specialty Real Estate † | − 0.7 | 8.0 | 9.9 | 5.7 |
| Moderate Allocation | − 5.3 | 5.1 | 5.5 | 4.8 |
| Long-term Bond | − 0.4 | 3.0 | 7.2 | 6.5 |
| World Bond † | − 2.0 | − 0.7 | 1.5 | 4.0 |
| High-Yield Taxable Bond † | − 5.6 | 1.0 | 3.6 | 5.5 |
| Long-term Municipal Bond | 3.2 | 2.8 | 5.8 | 4.2 |

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks, high-yield (lower rated) bonds, and sector-sepecific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.

# Change in Store for Money Markets

For decades, money market mutual funds have been a staple of investor portfolios. An innovation of the 1970s, they pooled small investors' liquid reserves to access higher yields previously available only to institutional buyers of short-term corporate and government debt. That innovation helped drive banking deregulation, adoption of the universal IRA, and rapid growth in a wide range of retail financial services, all during an extended period of relatively high interest rates.

As the saying goes, the rest is history, including the 2008-09 financial crisis which illustrated the potential for a destabilizing "run" on such funds if they experienced liquidity strains. Since then the Securities and Exchange Commission has crafted new money market fund regulations which are to be fully implemented by this October.

As fund managers reposition for the new regs, individual investors will be looking to the newly defined "retail" and "government" money market funds for the kind of stable, free-in-and-out "cash" reserve we've been used to. These categories will be allowed to maintain that stable net asset value ($1.00 per share) using the amortized cost method or rounding to the penny.

The SEC defines "retail" investors as natural persons plus certain personal trusts, retail brokerage accounts, participant-directed retirement plan accounts, etc. The *government* funds must hold at least 99.5% in cash, government securities, and/or repurchase agreements collateralized by such securities.

These new regs will *allow*, and could *require*, a money market fund to impose limited redemption fees and/or a temporary hold if it faces liquidity constraints. However, stable net asset value and ready liquidity are a money market fund's stock in trade, so redemption fees or holds would only be invoked under real financial duress. The SEC's new rules are intended to make that even less likely than before. ■

# Too rich to snare college financial aid? It *still* may be worth your while to file.

February was *Financial Aid Awareness* month. Hey, who knew?! But if you have a student heading for those hallowed halls of ivy next fall, there's still time to apply for financial aid, and maybe more reason than you thought.

The deadline is June 30th to submit the Free Application for Federal Student Aid (Fafsa) for the coming school year. *Wall Street Journal* columnist Veronica Dagher encourages affluent families to apply even if they're pretty sure they won't qualify for aid. She notes that colleges *also* need qualified students whose families *can* pay their way. A Fafsa on file may provide the schools on your student's wish list with that helpful information.

*Merit aid*, which generally is *not* based on a family's finances, often requires a Fafsa to have been submitted. Students ranking in the top 25% of a school's applicant pool may have the best chances of receiving merit aid. A Fafsa is also required to qualify for low-interest federal student loans. Some parents who can readily cover college costs still prefer to have a student take advantage of those favorable loan terms and be responsible for repaying some of that investment.

The Fafsa gathers data for a multi-factor analysis to determine a single number: the expected family contribution (EFC). Aid eligibility is defined as the difference between the full-year cost of attending an institution and the EFC. Students who don't qualify for aid to attend their own state university may well qualify for aid to go out of state or attend a private school.

Then there's the fact that a family's financial situation can change. The single biggest factor in setting the EFC is the parents' income. Sudden loss or material decline in even one parent's income could mean a big change in aid eligibility. At that point, it may be advantageous to have already filed a Fafsa that can be readily amended.

Finally, if two or more siblings' college years overlap, the EFC is roughly divided among them, significantly lowering that qualifying hurdle. At the very least, working through the Fafsa may help give your student a better idea of the serious money you're about to invest in his or her education. ■

# Little Time Left for Social Security Claiming Strategy

Last quarter we reported on a surprising component of last fall's Bipartisan Budget Act: the impending elimination of a popular strategy by which some couples can enhance their cumulative Social Security benefits. That "file-and-suspend" strategy works as follows:

• One spouse who has reached full retirement age files for Social Security but suspends receiving benefits to age 70 when they reach the maximum amount.

• The other spouse files a "restricted claim for spousal benefits" and receives *that* income while his or her *own* work-record benefit continues to accrue credits toward *its* maximum amount at age 70.

*After this April 30*, the ability to initiate file-and-suspend as described above goes away. But since last fall, planners have surveyed the new landscape and realized that for many couples, the restricted spousal claim *itself* is at least as valuable. That's the ability at full retirement age to claim spousal benefits while deferring the collection of one's own

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## *Surprised? Really?*

not their turning points.

A rather controversial U.S. Secretary of Defense once noted that there are those things we know, those things we know we don't know, and those things we don't know we don't know. More succinctly, it's not the bullet you can see that gets you.

Circlng back to the stock market's latest tug of war, January's decline was followed by a February-into-March rebound that was also widely unexpected. We all encounter some *true* surprises in our lives, but market sell-offs and economic soft spots probably should not be counted among them. ■

# Dialing Back Risk *May* Not Trim Returns

The numbers crunchers at BlackRock have come up with an interesting observation. A hypothetical $10,000 investment in the Standard & Poor's 500 Index would have grown to some $50 million. It's natural to assume that one would have to be willing to take the full roller-coaster ride – 100% of the downs as well as the ups – to achieve those results. But is that really the optimal gain/loss *capture ratio*?

BlackRock studied the hypothetical results from clipping off comparable percentages of the gains as well as the losses. Their labors suggested an apparent optimal capture ratio of 88%. In other words, assuming a portfolio strategy could be calibrated to capture just 88% of the upside while suffering only 88% of the downside would have seen that $10,000 investment grow to more than $58 million.

That's not to say it's easy to design a strategy that would consistently capture some precise share of each rise and fall. In fact, it's probably pretty tricky. Still, it might help you sleep a little more soundly to know that trimming the volatility of a portfolio a bit does not necessarily mean sacrificing return. Then again, if you've managed to stay invested since 1926, you're probably not losing much sleep anyway. ■

# Liar, Liar! Mom and Dad Are So Proud.

There was a time when every grade school student learned about young George Washington admitting that he had chopped down that cherry tree. Fortunately, George discovered the value of deception in time to cross the Delaware in the wee hours of December 26, 1776, and surprise a company of hungover Hessians for one of the colonists' first victories of the American Revolution.

Today, child development experts tell us that learning to lie, or at least shade the truth, is part of a child's healthy mental growth; just another developmental milestone like walking and talking." Research led by psychology professor Kang Lee at the University of Toronto suggests that 30% of verbal two-year-olds try out a fib here and there, as do half of three-year-olds and 80% of four-year-olds. Yes, *80%*.

According to Dr. Lee, lying requires two rather sophisticated capabilities: knowing what's in someone *else's* mind (as well as what they don't know) plus the power to plan ahead in choosing a strategic lie over the simple truth. The professor sees early liars as being "more successful in school and in their dealings with other kids on the playground."

It's something to bear in mind as the presidential campaign grinds on. Just think of all those politicians as overgrown, precocious four-year-olds. It will cast them in a more sympathetic light and help clarify much of what they have to say. ■

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work-record benefits to age 70.

The recent legislation doesn't eliminate that option until the end of *2019*. Those who were 62 by the end of 2015 can employ that strategy at full retirement age as long as the other spouse is collecting benefits or is old enough by this April 30th to file and suspend.

Those who were *not* yet 62 at the end of 2015 will, upon filing, automatically receive the higher of the spousal or their own work-record benefit. We might note that there are about 14 million Americans turning 66 during that four-year stretch.

**One last note: If you plan to file and suspend before May 1st**, there have been many reports that some Social Security agents are not quite up to speed on all of this. If you meet with resistance at your local SSA office, you may want to confirm your eligibility with your advisor and then file for your benefits online at *www.SSA.gov*. In the remarks section at the end of the application, write: "I want to suspend my benefits." Someone from SSA should contact you within a few days to verify the details. ■

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