BURKE
FINANCIAL STRATEGIES

Are Interest Rates Going to Zero?

John B. Burke | August 2019 Newsletter

In March, media outlets including the Wall Street Journal, CNBC and others reported that Kyle Bass, a successful hedge fund investor who profited from the collapse in 2008, said "interest rates will be at zero in 2020." Just this past Friday, The Financial Times ran a front-page markets insight piece titled "Shock and awe must be Fed response to threat of zero yields."

The mere possibility of zero rates might surprise you as our experience is that investors have generally been predicting that interest rates are going to go up. But this is what the Financial Times recently wrote: "Ten-year US Treasury yields could be headed to zero. This is not a bold prediction. This is not something that we hope happens. This is an observation of what is unfolding in the markets right in front of us."

We are concerned enough about the possibility that rates could go to zero to consider the implications. In this piece, we explain why we think rates might go to zero and what we think investors should do about it.

How plausible is it that rates can go to zero?

Let's start with this. Roughly one quarter of all government bonds in the world, worth more than $15 trillion, currently yield less than zero percent. That's right, less than zero. These include bonds issued by the German, Swiss and Japanese governments. In fact, the German 30-year bund yield recently turned negative. Let us translate. If you invest in a bond that yields less than zero and hold that bond to maturity, you will get less money back than you started with – guaranteed. As of this writing, you could lend money to the German government until August 15, 2048 and they promise to pay you back less than you lent them! Many factors contribute to this, including central bank bond purchases, low inflation and low economic growth.

If it is possible for those countries, it is possible here. The main reason that rates are so low in those countries is because they are on the verge of deflation. Deflation means that prices in general are going down. This may sound like a good idea. After all, who wouldn't want lower prices? But what is good for one is often bad for all. If prices in general are going down, a number of things start to happen in the economy. Shoppers choose to delay purchases as they wait for lower prices. If shoppers don't buy, manufacturers don't manufacture. If manufacturing slows, companies stop raising salaries and begin to lay people off. As salaries stagnate and people get laid off, the tendency to put off purchases only gets worse. In 1929, this scenario was set off by a stock market crash but became what we call the Great Depression because of this vicious deflationary spiral.

Prices are a key input to interest rates. Just as high inflation leads to high interest rates, low inflation or deflation leads to low interest rates. In slow economies, people don't borrow - they just save. If you have too few borrowers and too many savers, the price to lend goes down. The price to lend is the interest rate.

How Should Investors Prepare for this Possibility?

If investors knew for a fact that rates are going to zero, they would go out and buy 30-year bonds. Long term bonds appreciate the most when rates go down because the investor has locked in higher rates for a long time. If declining rates were also accompanied by a slowing economy, as is often the case, then investors who are selling stocks will likely be buying bonds, likely pushing up bond prices further.

The dilemma is that if instead rates go up, not down, those bonds will decline substantially in price. One of the market strategists that we read on a regular basis is Barry Knapp, the former Chief Market Strategist for Barclays. Mr. Knapp is predicting higher rates because he thinks the economy will rebound based on a recovery in worker productivity. A strengthening economy almost always leads to higher rates.

We think that Mr. Knapp's prediction is also plausible. Therefore, we think that investors should own some short-term bonds, in case he is right, and we think that investors should own some longer-term bonds in case of the zero-rate scenario. Zero rates can cause some big problems if rates stay at zero for an extended period of time. Our typical retiree's portfolio has approximately 40% invested in bonds. If that portion of the portfolio is yielding zero, it doesn't take math skills to realize that the retiree is going to have lower portfolio returns. And if returns are lower, the retiree may have to reduce their spending and lifestyle. This can mean missed vacations, hanging on to a used car longer and going to McDonald's instead of a restaurant.

For the portion of a portfolio not in bonds, we think investors should favor high dividend stocks from companies with rising sales. If rates go down to zero, investors are going to start looking for yield anywhere they can find it which means those high dividend stocks should attract some buyers. We believe that in a declining rate environment, investors will NOT want to own high growth/speculative stocks. A declining rate environment would likely be associated with slower growth with investors shunning risk, in our view.

If, on the other hand, the economy starts to strengthen, accompanied by higher yields, investors will likely look to companies that are benefitting from the economic growth - companies with a history of sales growth. Yes, we believe high growth stocks will do better in this scenario, but we don't think investors should risk being over-weighted in these stocks given the possibility of the zero-interest rate scenario.

One silver lining to a zero-rate scenario would be the opportunity to refinance debt. Anyone who has debt should already be considering whether it pays to refinance. Rates have already declined by about 1.4% since last summer.

As always, we are here to help. We will be reviewing your financial circumstances with you during your second half review to see if you should consider any changes. Call us if you would like to speak sooner.