STRATEGY INSIGHT

November 2019

People's United Advisors

## Economic Overview

| | 2Q'19 | 3Q'19 | 4Q'19 | 1Q'20 | 2Q'20 | 3Q'20 | 4Q'20 |
|---|---|---|---|---|---|---|---|
| Real GDP * | 2.0% | 1.9% | 1.7% | 1.7% | 1.9% | 1.8% | 1.8% |
| CPI (year over year)† | 1.6% | 1.7% | 2.0% | 2.2% | 2.0% | 2.0% | 2.0% |
| Unemployment Rate† | 3.7% | 3.5% | 3.6% | 3.7% | 3.7% | 3.8% | 3.8% |

estimates are shaded

* Quarter over quarter annualized † end of period

Increase from last reported    Decrease from last reported

Source: Bloomberg

# Negative Interest Rates? – Not in the U.S.

Interest rates throughout much of the developed world are negative. U.S. investors have wondered how negative rates are possible and whether rates could turn negative here.

Interest rates are set in several ways. Short-term rates are determined by central banks, who set the rates for banks that borrow directly from them or from each other on a short-term basis. Central banks use these rates to stimulate or to restrain bank lending and thereby stimulate or restrain economic growth.

Longer-term rates are set by the bond market through the prices investors pay for bonds. Higher prices translate into lower-rates, and lower prices into higher rates. Under normal conditions, longer-term rates are largely immune from the influence of central banks. Since the Great Recession, however, central banks have had a direct influence on longer term rates through the bond-buying programs that several central banks – including the U.S. Federal Reserve – have used to provide extra stimulus.

So, how do negative rates come about? In Europe and Japan, central banks have set negative policy rates in an attempt to stimulate bank lending. Banks with excess reserves can either lend the reserves or they can put them on deposit with the central bank and pay interest to the central bank – a negative interest rate.

But the negative rates in Europe and Japan are not confined to just short-term rates set by the monetary authorities. In Germany, bond yields are negative for maturities as long as 20 years. These negative yields are the direct result of investors paying more for the bonds than they will get in return in principal and interest payments.

Contrary to appearances, German investors are not crazy. Negative yields are effectively the insurance investors are paying to keep their savings safe. Japan and Germany have two of the oldest populations in the world. Both have cultures that promote thrift and value savings over current consumption. Inflation in both countries is low to non-existent. Prices declined on average in Japan from 2002 through 2013. In this environment, and with the supply of risk-free government bonds being squeezed by central bank bond-buying programs, risk-averse investors have no choice but to pay premiums for the safety of government bonds, even if the premiums are more than the interest by a not-unreasonable amount.

Could this happen in the United States? Almost certainly not. With a younger population that values current consumption and has higher inflation expectations, and an ample supply of government bonds due to a large budget deficit, negative rates are a remote possibility.

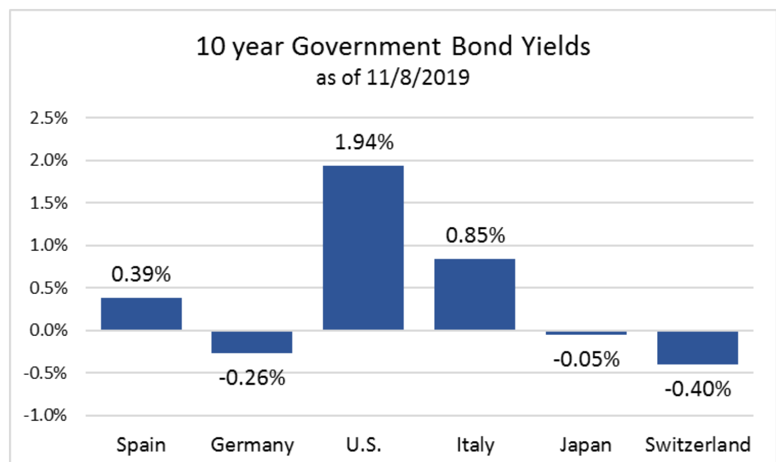


Chart Source: Bloomberg

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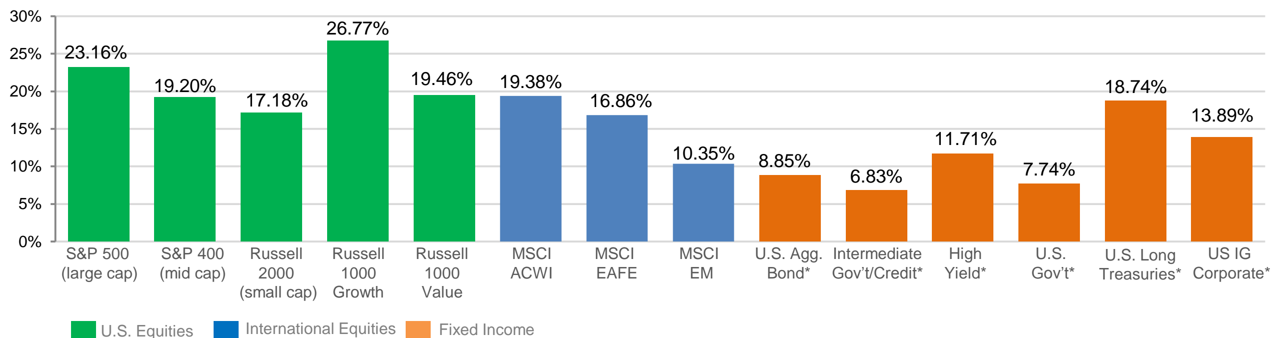
# Equity: Optimism About the Economy and a Quieting of Recession Fears

- Equity markets rose to new highs in October thanks to a combination of factors: optimism regarding U.S.-China trade, an interest rate cut, and stronger-than-expected third-quarter earnings.In addition, there is renewed optimism regarding the economy and a lack of recession in the near future. "Value" stocks have performed well, as shareholder yield factors (i.e. dividends, stock buybacks, free cash flow, and return on invested capital) drive stock performance. Most interesting has been the strength in small-cap stocks, a reflection of the restored confidence in the economy and the quieting of recession fears.
- So far, this fourth quarter is a reversal of a year ago, and we do not expect a repeat of last year. The factors that led to a down fourth quarter and a dramatic market pullback last December – the Fed raising rates, the worry these increases would pull down the economy, and the collapse of a trade agreement with China - are not present this year.

**Market Returns:** Year-to-Date as of October 31, 2019

Source: Bloomberg *Bloomberg Barclays' indices




# Fixed Income: Fed Follows Bond Market Advice

- The Fed cut rates a third time in 2019 at the end of October, to a range of 1.50-1.75%. This cut appears to undo the overtightening done at the end of 2018. The bond market was signaling to Fed Chairman Powell that at least three cuts in 2019 were needed, based on the shape of the yield curve.
- Powell has said that further cuts are on hold for now as policy is in a good place. Central bankers globally have been calling for fiscal policy to step up – that is, increases in government spending – to help support economic growth. There is very little additional accommodation that monetary policy can provide at this point.
- We've seen a liquidity-fueled risk asset rally post-cut but we would caution that until we see actual data start to turn positive, we believe that interest rates and by extension, credit, will continue to trade in a bit of a range here.

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