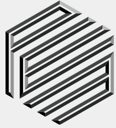

PALUMBO
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Weekly Commentary

June 8, 2020

Chief Investment Office PWM | 08 June, 2020
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Speaking Out

What happened to George Floyd was absolutely horrific. The video of that event is as disturbing as any we have seen in a very long time. **We stand with the peaceful protestors demanding change** and truly hope and pray that this is the last time there is a need to speak out.

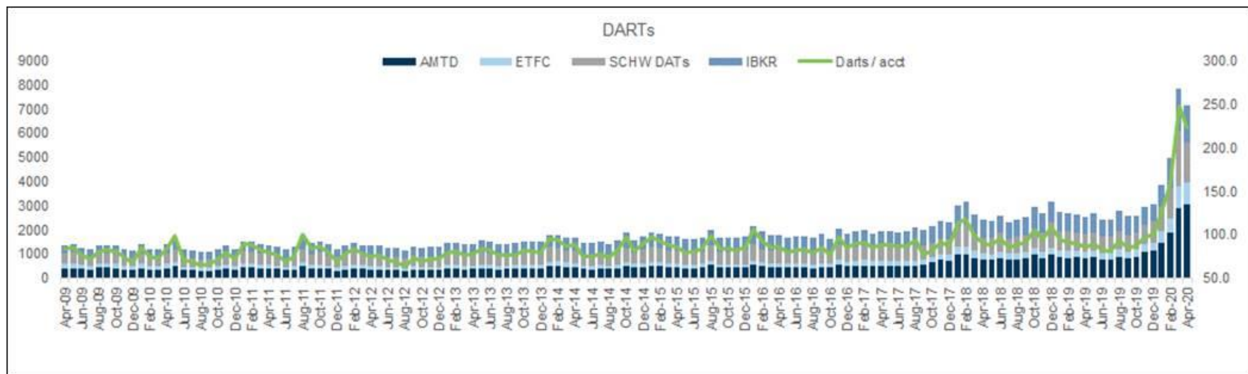
Recalling 1968

Watching the violent protests over the death of George Floyd, we can't help but travel back to 1968, when by all appearances the world, at least in the U.S., appeared to be on the verge of ending. We were in the middle of the TET offensive at the height of the Vietnam war and there were massive and often violent war protests. The civil rights movement was in full swing and within just over two months' time, both Martin Luther King, Jr. and Robert Kennedy were assassinated, sparking more massive violence and protests, not to mention the violence at the Democratic Convention in Chicago that year. Because of the above, the pandemic of 1968, which saw the H3N2 flu virus kill over 100,000 Americans, is largely forgotten. **The similarities between 1968 and today are striking.** Another common feature is a strong stock market. In 1968, a decline early in the year was fully recovered and the year ended with an almost 11% gain. There is an excellent book about the events of that year, titled 1968: The Year That Rocked the World, by Mark Kurlansky.

Markets This Week

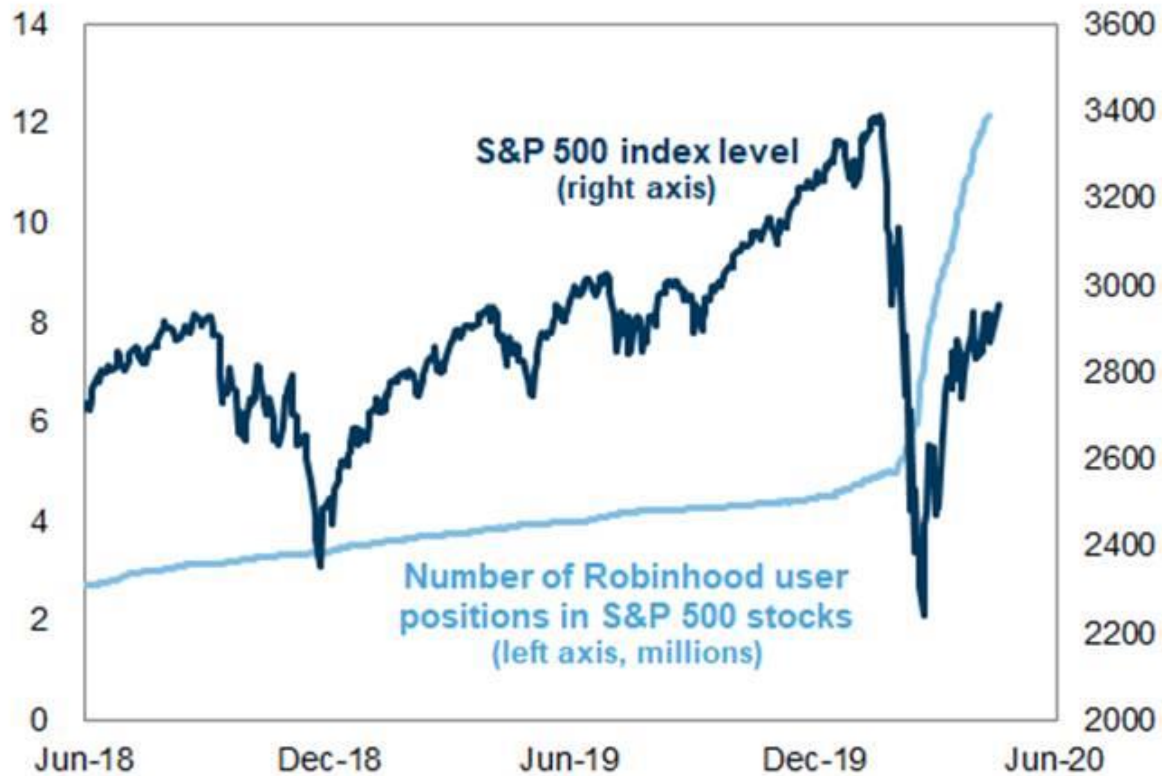
The stock market started strong and closed with a bang on the back of a shockingly good employment report on Friday. Intuitively, we were not quite as surprised because as states re-open, we would naturally expect an increase in employment. It just continues to amaze us how wrong Wall Street can be with their predictions. Their forecast was a decline of 8.3 million job loses, but instead there was a gain of 2.5 million. At any rate, it was hard not to be impressed with the gains in the markets, especially the continued rotation of strength to different sectors as well as to smaller capitalization stocks. In our standard performance chart below, we note that the Small and Mid -ap ETFs outperformed the S&P 500 by 2 to 3 percentage points for the week and in the sector data, the winners for the week were Energy, Finance, and Industrials, all benefiting from improving, albeit still weak, economic data. **All are signs of a market getting healthier.**

We’ve mentioned Bob Farrell’s ’10 Market Rules’ in the past and this week we want to point out Rule #5, which states: **The public buys the most at the top and the least at the bottom**. We only bring this up because retail investors have been piling into the stock market. The two charts below are from Goldman Sachs and are indicative of the retail frenzy that has been developing. By way of explanation, DARTs are Daily Average Revenue Trades, which is a metric used in the brokerage industry. This is data for Schwab, TD Ameritrade, E-Trade and Interactive Brokers. This puts the recent spike in activity into perspective over the last 10 years.

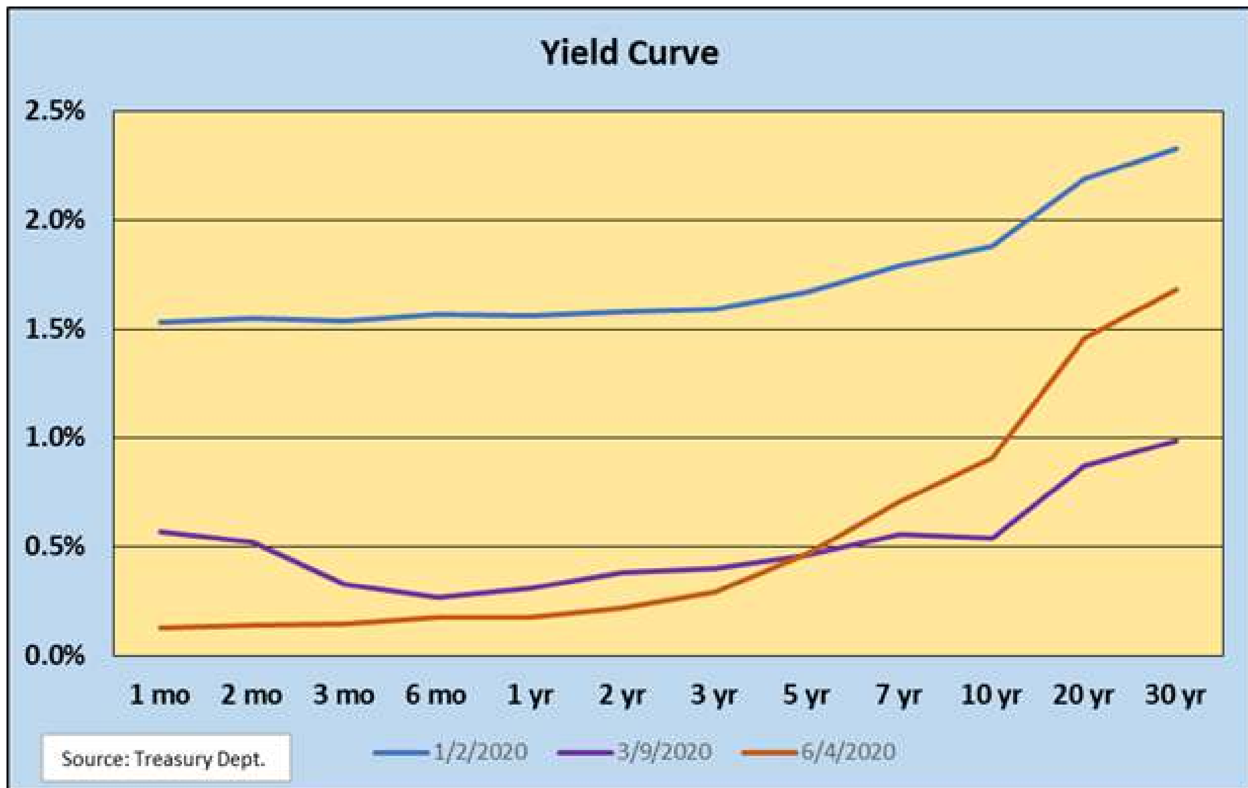


The situation is similar at Robin Hood, confirming that the retail investor has been extremely active in markets recently. We can’t help but think that this might be a Pavlovian response to the Fed taking drastic action to support markets. **The 11 year bull market that followed the Great Recession is one of the most unloved bull markets ever, but after the steep decline, it appears retail investors have decided now is the time to join the party.**

The trouble with rule number five is that it never tells you exactly when the public will be proven wrong. So, while this data puts a damper on the positives in the market, it does not rule out further gains. Nonetheless, we’d prefer if the ‘smart’ money was participating too.



Yield Curve Steepens as Economic Numbers Improve
There was plenty of action in the bond market this week as well **as the yield curve continued to steepen on initial signs of economic recovery and some growing inflation concerns.** The blue line at the top of the chart below is the yield curve at the beginning of the year, As the pandemic hit and the FED acted, the yield curve came crashing down (purple line) and slightly inverted at its worst. More recently, the yield curve has steepened (orange line), which reflects a more constructive view of the economy and creates a more friendly environment for banks and financial stocks.



Will We Move from ZIRP to NIRP?

- **In 2009, the Federal Reserve (FED) went to ZIRP (Zero Interest Rate Policy)** in response to the Great Recession of 2008-09.
- At the same time, the **ECB utilized a different tact - NIRP (Negative Interest Rate Policy).**
- **FED Chair Powell claims he does not want to move to ZIRP.**
- Does ZIRP work? The **evidence is mixed, but markets are predicting it will arrive anyway.**
- What happens **when rates hit the 'lower bound' (0%)** is not predictable.
- We risk **unintended consequences.**

We are 12 years removed from a burst economic bubble that caused an economic contraction only rivaled by the Great Depression. Although it may have felt like we were back to normal after that crisis, the grim reality is that we were not. The extraordinary methods used by the FED had yet to be unwound when the current crisis hit. Today we are facing yet another serious economic crisis with an economic contraction on par with the Great Depression.
Back in 2009, the Fed opened its playbook and pulled out a policy that until that time, had only been discussed in theory – Quantitative Easing, or QE, which simply means that the Fed exerts additional control over interest rates by buying Treasury securities in the open market to further drive down interest rates, with the additional benefit that as they pay for these bonds, it injects more money into the economy. Both of these things should be beneficial to a recovering economy as lower rates encourages new investment and ample liquidity implies that there is money to lend

at these low rates. QE has become so engrained in the economy now that the FED appears to view this as 'normal' policy.

With the advent of this most recent crisis, the FED has again leaned on QE, although they have added several additional experimental twists including the ability to buy other securities, like corporate bonds, municipal bonds, even bond ETFs. In addition, they have resorted to 'helicopter money', a term coined by former FED Chair Bernanke to describe extreme ways to inject money into the economy. The one time, $1,200 checks sent to citizens is an example of helicopter money.

The one policy that the FED has not embraced (some would insert 'yet' here) is NIRP - Negative Interest Rate Policy. What we experienced after the Housing crisis was ZIRP – Zero Interest Rate Policy. The difference between the two is quite significant. ZIRP implicitly recognizes that interest rates have a natural 'lower bound' of zero. There is no logical reason to deposit money in a bank if the bank will not pay you for the use of your money, thus an interest rate of zero was viewed as the lower bound.

NIRP, on the other hand implies that you actually pay to invest your money. **Imagine that if you brought your money to the bank and were told that they would charge you some percentage of that money to hold it, in effect guaranteeing a loss for your bank deposit.** It sounds completely non-sensical, except at very low levels of negative rates under the presumption that you might be willing to pay some small fee for the safety of the bank holding the money, as opposed to insecurity of stuffing your mattress. As crazy at NIRP sounds, it is an economic experiment that has been used in Japan for many years and in the EU since 2014. And market prices are implying that the FED will be forced to go the same route. In light of that, we thought it would be useful to open a discussion on ZIRP and NIRP and what it might mean for the U.S. economy.

The theoretical background for both ZIRP and NIRP is to create an incentive to spend and a disincentive to save. There is little reason to save your money if it earns nothing or costs you money. You might as well spend it. This creates financial repression - savers are punished for saving money, which is, and has been, a very real conundrum for retirees that would ideally prefer to invest in safe bonds, rather than risky stocks in their retirement. They are forced to take on more risk in their quest for a reasonable return, which explains the substantial interest in any security that provides a reasonable income over the last several years. The trouble has been that the many new products created to provide this income have had hidden risks that were not fully understood until too late. It is a great example of the law of unintended consequences.

So, if ZIRP and NIRP create financial repression, why do we use these policies? The theoretical answer here is quite simple. The economy is driven by spending. The more we spend, the more the businesses we spend at have money to pay employees and they, in turn, go out and spend more. GDP, the measure we use to gauge economic activity is largely a measure of spending. So, both ZIRP and NIRP encourage us to spend more and thus help the economy recover faster. This is really just an

extension of normal interest rate policy from 40-50 years ago. Back then, when we had a recession, the FED would lower interest rates (just not anywhere close to zero) to provide the same boost. Lower rates encourage spending and recovery and discourages saving by limited the returns on saving. **The difference today is that we are dealing with extremes – zero rates or even negative interest rates --- and when dealing with extremes it is very hard to tell if these policies are helping or not, because there is greater risk of unintended consequences.**

It can certainly be argued that these policies prevented us from tumbling into the economic abyss. In that sense **these policies have been very effective at the time of the emergency, but once the emergency was over, we have been unable to return to the prior normalcy, and in that sense, these policies have proven to be lacking** at the extremes, the 'zero bound', of interest rates.
A significant risk of rates being at or below the lower bound is a liquidity trap. **A liquidity trap can occur when interest rates are very low and savings rates are high, which makes monetary policy ineffective** (i.e. it does NOT promote spending). This might occur because savers, in anticipation of rising rates, might prefer to hold cash rather than bonds, as bond prices would decline when rates rose. This behavior would be precisely the opposite of what ZIRP and NIRP policies are intended to do.

Banks also face a potential problem with negative rates because the banks would lose money on the reserves they are required to hold by law and banks may be reticent to pass those negative rates on to customers for fear of losing those customers. That could curtail lending, working against an economic recovery.
If negative rates do get passed along, **are U.S. investors willing to park money in money market funds that have a negative yield?** Massive withdrawals from money market funds could be very disruptive in commercial paper and other short term credit markets, rekindling roadblocks in debt markets and by extension roadblocks to recovery.

A fear we have that is not discussed often is that **chronically low rates will tend to pull demand forward**. Low or zero rates can spur demand, but the question is whether that is new demand, or simply demand that would have appeared in the future anyway. In other words, does the increase in demand today, create reduced demand in the future because we have reduced the future need? This may be precisely why we have been unable to normalize since the Great Recession. We continue to pull demand forward and any attempt to normalize monetary policy is therefore quickly met with reduced demand, making it extremely difficult to get back to a traditionally normal monetary policy.

There are no easy answers here. According to a WSJ story "The European Central Bank concluded in a recent paper that the policy, introduced in the 19-nation eurozone in 2014, boosted bank lending and aided economic growth. Yet a 2019 study by former U.S. Treasury Secretary Lawrence Summers and colleagues found that by squeezing bank profits, negative policy rates in Sweden prompted banks to reduce lending rather

than increase it. By all appearances, slightly negative rates may well be in the cards for the U.S. despite Chairman Powell's declarations.

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