REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
denewiler@msn.com
www.growmydollar.com

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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

It hasn't happened in 5000 years, so maybe it is not a good thing. We have been dealing with low interest rates for several years now, however, we have now entered negative territory with about one third of the worlds' sovereign debt. Maybe it wouldn't matter much, except that all assets are priced based on what is called the risk premium. It is the additional amount of return above a "risk free" asset which is government debt. It is important to know the impact this has on all investments.

The effect interest rates have on buying a house is a good example of how interest rates effect investments. The lower interest rates go, the larger the house you can afford with the same payment. A $300,000 mortgage costs $1,350/month when rates are 3.5%. If mortgage rates are at 5%, the same monthly payment goes to $1,610. It then takes 20% more income to qualify, or you have to buy a house that costs $50,000 less. All of these variables play into how financial assets perform in a changing interest rate environment. It is estimated that $10 trillion of debt currently has negative interest rates. Just to have a little fun, let's assume the average rate is negative .1%. You are offered the gift of $10 trillion if you agree to hold the money for two years. The money would cost you $10 billion a year in interest, so in two years when the funds are yours free and clear, you are bankrupt. There are only a handful of people in the world that could take that deal. It makes you wonder why anyone is buying this stuff at negative interest rates, especially since no one has for 5,000 years. The whole point of loaning money is that the lender is supposed make something. We live in strange times.

This principle applies to stock prices too. Investors will pay more for $1 of earnings if interest rates are lower, and more importantly, if they are expected to stay low for a while. Economists used to think that if more dollars were injected into the economy, inflation would follow. It isn't working that way now, or at least not yet. The bond market is priced expecting that five-year interest rates will pay 1.93% five years from now. This is called the forward rate. The current five-year Treasury note yields 1.09%. This says that the financial markets basically think that these low interest rates are going to be with us for several more years. If this is actually the case, the stock market is probably reasonably priced, or maybe even cheap.

If you are wondering what to do in this scenario, consider a sustainable growing income. This is simply buying investments that have the ability to increase their payments over time. If you start at a reasonable level of return, at least 3%, and the income grows by 5% annually, your income will double in 15 years. The goal is to have the higher income offset the effect of higher interest rates. If your income has increased, you can still afford a $300,000 mortgage. The only way a fixed interest rate can adjust to higher interest rates is for the principle value to decline. In a negative interest rate environment, there are a lot of investments that have a bad surprise built into them if we ever get back to a normal world, and someday we will. The stock market isn't the only place to find a sustainable growing income, but you won't find an income stream that endures higher costs in the fixed debt market. This doesn't apply to short-term maturities. They may not pay much, however, they should be considered an asset class since they offer the opportunity to preserve capital. Really great investors have the ability to provide liquidity when everybody else is running for the exits.

In the mean-time a rising income will turn profitable much faster than a fixed income will in times of stress. If the bond market is correct and it does take another 5 years to see any substantial pickup in yield, a growing income makes even more sense. Just beware of anyone offering free money, you might end up bankrupt.