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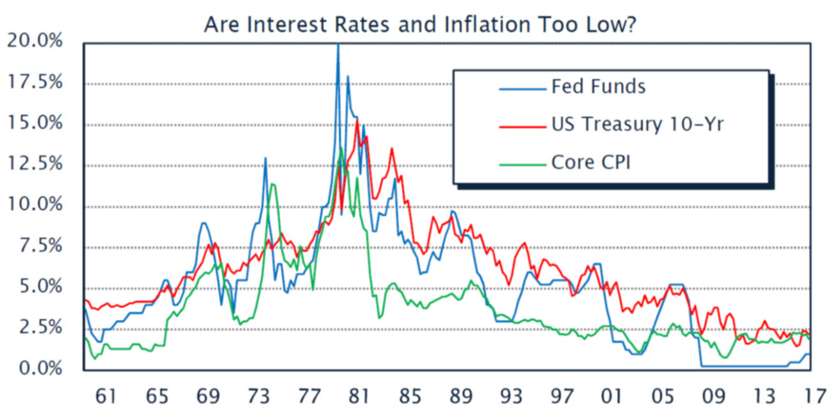
Agincourt Capital Management, LLC

INVESTMENT UPDATE

Just ten years ago, the idea of interest rates falling to zero seemed impossible. Dusty textbooks showed that US interest rates had fallen nearly to zero during the Great Depression; more recently, Japanese interest rates had been below 1% at times, but those were viewed as special cases. Virtually nobody was predicting zero percent interest rates for the US. But after the bottom dropped out of the housing market and the banking system teetered on the precipice of collapse at the end of 2008, the US Federal Reserve dropped the overnight Fed funds lending rate to zero.

It was viewed as a desperate, temporary move designed to stimulate the US and global economies by providing money—virtually free money—from the world's most powerful central bank. But it did not prove to be temporary, and in fairly short order it didn't seem so desperate either, as zero-rate policies became the norm among all developed economies over the next few years. As we now know, longer-term rates followed suit, moving towards zero—and in many cases, below zero—as central banks added bond purchase programs (AKA quantitative easing, or "QE") to their policy playbooks, driving down borrowing rates "out the yield curve" to further encourage businesses and individuals to borrow and stimulate economic growth.



Now that the Fed has begun to remove "policy accommodation" by pushing up the Fed funds rate (followed, perhaps as early as year-end, by beginning to allow some of its bond holdings to mature without replacing them), it's time to think about the future of zero-rate policies. Optimally, a central bank would prefer not to go down the zero-rate path, for obvious reasons—a zero-rate policy means that when the economy is very weak, the central bank will have no choice but to take additional measures (e.g., bond purchasing programs) once the funds rate has reached zero in order to further stimulate growth. Prior to 2008, the Fed had never before used QE to stimulate growth—it's not a traditional tool—and it would prefer to never have to resort to these "extraordinary" policies again.

Unfortunately, if we believe a study published last month by Fed economists Michael Kiley and John Roberts, we are likely to see many more of these "zero lower bound" (ZLB) events in the future. In fact, under the assumptions that the authors set out, they believe that short-term rates could be at the ZLB as much as 30 to 40 percent of the time. Not only does this mean that the Fed will be forced to dig into its toolbag and engage in extraordinary measures far more often, but it also means that we are looking at a future where the economy is chronically underperforming, with little demand for credit and sub-par growth.

The root of the problem is inflation, or more precisely, the lack of it. It would appear that the combination of aging global populations, increasing demand for "safe" investments, and higher savings rates have driven real, inflation-adjusted interest rates lower. Adding to this problem is that central banks have been very successful not just in wiping out inflation in developed economies, but in driving down expectations of future inflation as well. Where investors used to demand a 2 or 3 percent premium above the current rate of inflation to buy a longer-dated government bond, investors are so confident that inflation will remain low in the future that these premiums have shrunk to zero.

Wading into the discussion of this paper is none other than former Fed Chair Ben Bernanke, who was credited by the authors for his "comments and suggestions" while doing their research. In the blog that he writes for the Brookings Institution, Bernanke pointed out that while investors don't seem to be demanding much of a premium over inflation when buying bonds, the financial markets haven't lowered their expectations of future inflation, at least when judging by the pricing of financial instruments tied to inflation over the long horizon. Comparing inflation-adjusted Treasury bonds and "ordinary" Treasuries, Bernanke noted that inflation expectations have been persistently stable at approximately 2 percent; using zero-coupon inflation swaps, inflation expectations are at 2.25 percent as far as 30 years into the future.

So which is it? If indeed inflation is going to be too low—i.e., never getting above 2 percent, even when (as now) we're in a situation of full employment, then we should expect to see frequent and prolonged periods where the Fed will have to lower the funds rate to zero, and economic growth, productivity, employment and fiscal balances will suffer. Or will something change in the future to keep inflation from being too low, allowing the US economy to "get back to normal" with a healthier economy and less reliance on QE and other "toolbag" solutions?

Bernanke points to a possible way to reconcile the quandary, namely, that investors have confidence that in the future the Fed will do whatever it takes to get inflation high enough so that we will avoid prolonged periods of zero interest rates. The study's main flaw, according to the former Chair, is that it assumes that the Fed will use only its pre-crisis approaches in dealing with future bouts of chronically low interest rates. But investors know better, and are convinced that the Fed will once again resort to QE, et al, to stimulate the economy and that economic growth won't be stunted by prolonged bouts of ultra-low interest rates.

Bernanke followed up his first response on this topic with another, the following day, spelling out what else the Fed could do to help keep the US economy from flirting with zero rate scenarios, including an idea that would have been anathema in years' past: The Fed could raise the inflation target.

By raising its inflation target from 2 percent to, say, 3 percent, the Fed would allow, during periods of economic expansion, other interest rates to rise by at least an additional 1 percent, helping to put some distance above the dreaded zero lower bound. The key advantage of this policy change is that implementation would be pretty straightforward, since the Fed is already targeting an inflation number. Bernanke does point to some problems, the main one being that it could be disruptive, after years of finely-tuning its approach and convincing investors that the Fed would keep inflation low, to now persuade the public that higher inflation is a good thing. "Re-anchoring" expectations after all these years could damage the Fed's credibility, especially if this is viewed as a tactical move. He points out that the experiment could fail, and interest rates might not rise (the whole point of the exercise) if the investing public doesn't believe that the Fed can achieve its goal of moving inflation higher, or if other policymakers undermine the Fed's efforts. This is arguably Bernanke's biggest objection, as he sees the preservation of the Fed's credibility being critically important.

As an alternative, Bernanke pointed out that the Fed could simply keep the funds rate at near-zero well into the recovery, allowing inflation to creep up as the economy uses up its slack capacity. This would be preceded by statements communicating the Fed's intentions, with the understanding that the purpose is to move the economy to a faster growth trajectory. A similar solution is "price-level targeting," where the Fed would commit to running inflation above its 2 percent target for a period of time roughly equal to the period where inflation was running below the target. For example, if the economy cools and inflation averages 1.5 percent for three years then the Fed would allow inflation to run at a rate of 2.5 percent for at least three years once the economy recovers. These "make up" strategies have the advantage of being more flexible than simply raising the inflation target to 3 percent. For one thing, they wouldn't commit the Fed to a fixed interest rate target that might need to be once again raised or lowered over time.

Obviously, these are all long-term considerations as the Fed sorts through its options in dealing with future policy. These public deliberations are the first step in formulating strategies for the future, and will no doubt spur (if they haven't already) private discussions among the Fed's policy-making Open Market Committee that could begin to show up in the minutes which are published soon after each Committee meeting.

In the meantime, the Fed looks almost certain to raise the funds rate again in June, and has announced its intention to bump the overnight rate up once more after that in the second half of the year. This, despite the fact that core inflation is at or below the Fed's 2 percent target (depending on whether you use the CPI or the PCE measure of core inflation). It seems clear that in 2017, the Fed will continue to use its old playbook, with a couple of hastily-written variations, instead of looking for ways to avoid another corrosive zero rate environment. When will the Fed adopt new approaches to keeping us above the zero rate bound? That will, unfortunately, probably have to wait until we've had another dose of it.

In other news, two members of our investment team, Shannon Hughes and Ryon Acey, have earned the title of Portfolio Manager. Shannon has been with Agincourt since 2000 and Ryon joined us in 2004. Please join us in congratulating these two outstanding investment professionals!