Intelligent Investing

KINNELL & CO

Negative Interest Rates on the Horizon

2020 is proving to be a momentous year in financial markets with events not only unfolding at a rapid rate but at a magnitude unseen since the Depression. Central Banks have responded with both barrels and so far, succeeded in re-floating asset prices from the depths of March and April's meltdown. As we wrote in May the recovery seemed rational if you believed that 2021 would be significantly better than 2020 economically but actual recovery would be needed to sustain further asset price gains. Since May markets have continued higher but new forces have come into play.

Expectations that Central Banks will do whatever it takes to rescue asset prices have strengthened through every crisis since the 1998 bailout of Long-Term Capital Management, an ironic name given its failure. After that came the Dotcom Crash in 2000-2001 and then the housing bust and Global Financial Crisis of 2008-2009 to be followed by European sovereign debt issues in 2011-2012. Now the Covid Crash of 2020 has seen Central Banks take things to another level again. Already interest rate across the Western world are close to zero per cent and some countries in Europe have already gone into negative territory. The zero or negative interest rate trend is broadening leaving investors with fewer options to earn income returns. New Zealand is no different.

The Official Cash Rate is currently 0.25% but there is much speculation that by early 2021 the RBNZ will take the OCR into negative territory in conjunction with a Term Lending facility that will provide very low cost loans to New Zealand trading banks. This is further undermining already low term deposit returns which have fallen from around 2% to 1-1.5% over recent months and may head to 1% or less in 2021. The Term Lending facility is just the latest tool in the RBNZ's escalating response to persistently low inflation. Already for the first time ever the RBNZ has been buying New Zealand Government Bonds this year as a monetary policy tool and in a matter of months has under its Large-Scale Asset Purchase programme bought around NZ$30b of NZ Government debt. With an announced limit of NZ$100b (already increased twice from an initial NZ$30b) the RBNZ may end up owning over 50% of all NZ Government debt by late 2021 or early 2022. This is truly extraordinary so what is an investor to do?

With the prospect of several years of low to zero, or even negative interest rates the traditional 60/40 Growth and Income portfolio is very challenged. Whatever the income asset portion of the portfolio is it is likely to earn essentially no income. There are only two reasons we can think of to own low or no yielding deposits and bonds: 1) to provide a cushioning effect to the volatility from the Growth assets in a portfolio and 2) to provide the option of converting some of the low yielding cash into Growth assets when market volatility provides reasonable opportunities. This market environment is primarily why share markets are seeming to defy gravity at present. But the absence of good alternatives does not mean all shares are worth buying. There is building evidence of an asset price bubble forming with zero interest rates funding rising speculation. We think it is important to remain disciplined in this environment.

Many investors will be concerned about what they should do in this zero-interest rate scramble to own assets that provide either the opportunity for growth, think big Tech, or income, think utilities and listed property. Although the price of most assets is rising there are two things investors should focus on. First, buy good assets that have strong earnings and sound balance sheets. This year has been a great stress test of whether a business can weather truly horrible economic conditions. Secondly, maintain a decent amount of cash so that when there is market volatility you can add to strong companies rather than being scared of what might happen next when markets are falling. Central Banks have been taking us down the path of low to zero interest rates for twenty years and the way out of this is not at all clear. Eventually the low interest rates and excess market liquidity might stoke actual inflation but that is likely to be years away. In the meantime, you need to take steps to earn a reasonable return on your capital. That return though will likely be lower than in the past.

The companies mentioned above are named to further the discussion. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends discussed above.

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