COMPASS WATCH

Summer 2019 Newsletter

ARE THERE POSITIVE OUTCOMES FROM NEGATIVE RATES?

Negative-yielding debt surpassed $13 trillion in June 2019, doubling since December and now making up around twenty-five percent of global debt (mainly in Europe and Japan)[1]. Remarkably, negative-rate bonds continue to be issued, and investors continue to buy them.

Interest rates are the single most important policy tool used by central banks to influence inflation (or conversely, combat deflation) throughout an economy. Lowering interest rates is intended to incentivize banks to *lend* money and to encourage businesses and consumers to *spend* money rather than paying a fee to keep it safe at a bank.

How did we get here?

It all began with the 2008 financial crisis. The European Central Bank introduced its negative interest rate policy in 2014 and the Bank of Japan followed in 2016 in a bold move to stimulate its economy and overcome persistent deflationary pressures (largely due to aging demographics and technology). However, the impact of these policies on the *foreign* exchange market has been favorable. When negative interest rates are in place, investors tend to search for better returns in foreign markets (one reason the 10-year U.S. Treasury note is currently yielding below 2%), which sends a currency's valuation lower. Lower currency valuations help boost exports by making them more attractively priced around the world.

Why invest in a bond that will lose money?

Bonds can be one of the safest assets, so many investors seek them out in times of market stress (e.g., current China-U.S. trade war, dot-com bubble). A bond can have a positive coupon issued by a government or corporation, but once the bond begins trading, high demand by investors can push its price up—and therefore its yield down. Some mutual funds track government bond indexes, meaning the mutual fund must buy the bond(s) regardless of yield.

In Germany, 85% of the government bond market is underwater—investors effectively *pay* the German government for the privilege of buying its bonds.

Is this a reason to worry?

Negative interest rates are at odds with basic principles of the global financial system: If a bank or business lends money for longer durations, investors should receive a higher return. The time value of money is disappearing, pushing investors into riskier assets in the hunt for returns, raising the chance of asset bubbles in the financial and real estate markets.

Now, as to whether this could happen in the United States, it seems doubtful. The Federal Reserve has stated that negative interest rates are not a policy they would like to pursue (however, quantitative easing was not anticipated either). Secondly, the Federal Reserve is unsure that negative interest rates are even legal under its charter.

The United States has had a more robust recovery than most other major countries. We don't have deflation. One consequence for investors is that yields are so low around the world, it tends to keep a cap on U.S. yields. Domestic yields are unlikely to move up significantly while there are still so many negative yielding bonds in the global marketplace.

Who benefits from negative interest rates?

Governments and corporations. The incentive to borrow money is never greater than when you are being paid to do so. These institutions are effectively being subsidized to issue debt. Negative interest rates seem ludicrous: Why would investors buy a government bond with a negative yield? But this is precisely what central banks want investors to consider. The goal of central banks is to incentivize investors to shift money *away from government bonds* and into something more actively productive, thus stimulating the economy.

A better way forward

At Compass, we have been following a single fixed-income discipline successfully since 1988. We construct our bond portfolios by equally weighting our maturities 1–10 years. We "ladder" to mitigate risk and control volatility within the portfolio. The primary goal of a laddered bond portfolio is to achieve a total return over *various* interest rate cycles comparable to that of a longer-term bond, but with *less* market risk. We also have the flexibility to customize our tax-exempt portfolios (i.e., purchase state-specific or national bonds depending on a client's state of residency). Additionally, our clients benefit from the "institutional" pricing we can leverage from the bond dealers with whom we do business.

If control over your bond investment decisions is important to you, utilizing a ladder approach of high-quality individual bonds is appropriate. The simplicity and flexibility of this approach allows investors to customize a portfolio for diversification, quality, and maturity, while generating a predictable and ***positive*** income stream.

[1]Bloomberg

FIRM

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AUM

$1.4 billion

INCEPTION

1988

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3) Join the CFA® Institute; 4) Commit to abide by, and annually reaffirm, their adherence to the CFA® Institute Code of Ethics and standards of Professional Conduct.

CHRIS NUTH PASSES LEVEL III OF CFA® EXAM

Congratulations to Chris Nuth, Portfolio Administrator, for passing the third and final level of the CFA® exam. Chris was among a record 250,000 candidates from around the world who registered to take the exams in June and the pass rate for Level III was 56% .

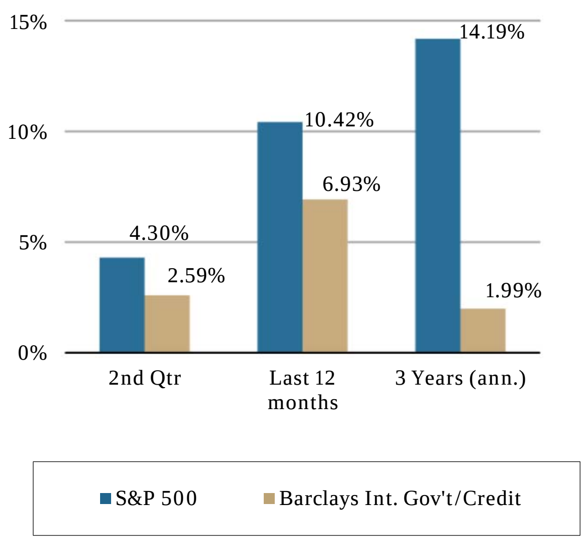
The Chartered Financial Analyst® credential is a rigorous and highly regarded certification program and we're extremely proud of Chris for passing all three levels in three consecutive years. The curriculum includes ethical and professional standards, quantitative methods, corporate finance, and equity and fixed income investments.

Chris joined Compass in 2017 and his role has expanded to include more investment related responsibilities. When Chris

formalizes all the designation requirements, he will join three existing CFA® charterholders at Compass and approximately 150,000 CFA® charterholders worldwide in more than 165 countries.

MARKET INDICES

Total Return as of 6/30/19



For more information regarding our company or results, please contact us at investors@compasscap.com.