MARKET MONITOR

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It's Easier to find a Unicorn than a Safe Investment with High Yield

BY: MICHAEL ALEXENKO, CFA

If you think our interest rates are low, take a look around the world. Japan, Germany and Switzerland are all in negative interest rate territory. The Eurozone in aggregate has a negative .4% interest rate on 10-year government bonds. This means that anyone buying a newly issued government bond from these countries with a negative yield will lose money on the original invested amount. Adding more pressure to global interest rates is the August 4th announcement by the Bank of England to lower its interest rate and expand more bond buying. Britain's 10-year government bond rate is one of the more generous at a rate of .65%.

These are extraordinary outcomes caused by a couple of events that are somewhat connected. In 2008 our mortgage market was in a meltdown as a result of years of sloppy lending practices that allowed too many people to obtain home loans they could not repay. The second issue is that we have aging populations around the world and this has made it difficult for economies to grow. As people retire they leave the workforce and no longer add to economic output. An aging population results in a larger number of people wanting to sell homes to a smaller pool of buyers, because there aren't enough young people to buy houses. This issue continues today, especially in a state like Illinois where outrageous real estate taxes exacerbate the problem.

In response to a deep recession and financial market turmoil, the Federal Reserve was one of the first central banks to initiate excessively loose monetary policy (aka, money printing). The idea was to drive down interest rates so companies and government could borrow at low rates and it would be cheaper for them to fund growth and operations. The low rates would also make it unattractive for people to deposit money in banks and they would instead buy riskier assets like stocks and real estate. This would drive up asset prices and make people feel wealthier. The wealthier the people feel the more they spend, and this would spur economic activity. Some of this has worked so well that people are now left with few alternatives as to where they can invest money.

We've been living in a world where normal economic activity has been distorted by approximately $12 trillion of money printed in the past decade according to pbs.org. Massive intervention like this causes people and businesses to make cockeyed financial decisions. I don't want my clients or readers of this newsletter to be drawn into the mix by pursuing ideas they would otherwise avoid.

Investment	Distribution Yield	Max % lost during 2015/2016 Market Correction
Vanguard Hi-Yield Bonds	4.97%	-8.54%
iShares High-Dividend	3.38%	-12.1%
S&P 500	2.47%	-14.1%
Cohen & Steers Real Estate	2.98%	-14.6%
Calamos Strategic Total Return*	9.50%	-24.4%

*Distribution yield includes partial principal repayment

For the past 3 ½ years, bonds have returned about 2.75% on average while the S&P 500 has added close to 15% annually. You'd think that investors would be pretty satisfied with these kinds of results, but 2015 wasn't a strong year and it appears that people have an intuitive feeling that global economic activity doesn't seem to justify stock markets trading at all-time highs. These are reasons we are reading about people searching for safe investments that deliver higher yields than the 1.5% that is currently earned on a U.S. 10-year treasury bond. They know they have to be invested, but there may be an underlying fear of committing too much to assets that feel overpriced.

Let's put to rest the idea that today safe investments exist that will yield 4% or 5%. Regardless of what may have been possible 15 years ago it is no longer available today. You may as well be looking for a unicorn at the end of the rainbow. Central Banks around the world have eliminated normal yielding bank deposits and government bonds which have dried up reasonable consistent rates of return.

It's understandable why people continue to cling to the hope that safer high-yielding investments can be found. Some of the misinformation is

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High Return with Low Risk? It doesn't Exist.

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promoted by brokers pushing annuities as a solution or closed end mutual funds. Also you'll hear commentators and journalists disseminate the idea that high dividend stocks and hi-yield bonds are the right area to harvest fat yields.

Some of these investments might be appropriate for a smaller percentage of a person's portfolio but none of them are safe investments. See the comparative chart that displays yields and price volatility for a few investment alternatives. It gives you a sense for the level of risk associated with each one.

When you purchase a closed end mutual fund that might focus on preferred stocks and it boasts a distribution yield of 9.5% it doesn't deliver its high yield without a corresponding level of risk. Nor does a hi-yield bond mutual fund which will experience some real damage if the stock market drops by 15%-20%. Hi-yield bonds are not a substitute for a certificate of deposit. They have significant risk, which is why I include them into my client accounts at a low percentage of overall assets. Annuities are one of the best packaged devices I've seen. But once you peel back the layers you see expensive products with what amounts to phantom price protections and a tax time bomb waiting for you when you want to withdraw funds.

Market movements and developments understandably can cause us to look for better ways to put our money to work. Incorporating some ideas into a well-diversified portfolio can be helpful but don't fall into a trap of believing that the "low risk/high return" unicorn lives.

Market Monitor: Negative Interest Rates Never Before Seen in our History

By: Michael Alexenko, CFA

If a six quarter earnings recession and the apocalyptic fear spread by the Brexit vote can't do-in the stock market, then it's hard to say if anything can pierce the armor protecting stocks. But if the armor is removed we might have a different story. It's been seven years of extraordinary measures by the Federal Reserve and those measures have been the body armor that the market has worn to help protect it against a profits recession and 1% GDP growth.

At the end of 2015, The Federal Reserve did threaten four interest rate hikes in 2016 which at the time sounded like a death wish, and it still does today. Now it looks like there may be no rate hikes this year. The central bank has made itself the focus of the markets because its policy of very low rates makes any increase a meaningful percentage change from the base it has created. The best outcome we can hope for is one where our economy begins to have stable growth which might allow for a gradual rise in interest rates which would avoid a shock to markets. We have to hope for the best and prepare for the worst because according to James Grant of the *Interest Rate Observer*, in the history of man we have never had negative interest rates and we now have almost $12 trillion worth of negative yielding bonds worldwide.