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Policy Uncertainty

Ultra-low interest rates may be solving one problem but creating another

- In the wake of "Brexit," central banks reasserted themselves over markets in a big way in Q3, sending bond yields to historic lows.

- The recent wave of populism in the developed world is targeting institutions that have been supportive of capital markets for the better part of 70 years. To the extent these political movements prevail, they would likely carry negative economic consequences.

- Ultra-low interest rates are increasingly being blamed for contributing to the anemic growth and wealth inequality that may be fueling these populist sentiments, further limiting the Fed's policy options.

- Rain portfolios remain positioned at the cautious end of client objectives until US elections in November and the anticipated rate hike by the Fed in December help clarify some of the extreme policy uncertainty hanging over markets at the moment.

Market Update:

After a brief rebound in early July from the late-June Brexit selloff, Q3 turned out to be a relatively sleepy quarter for most assets (when compared to Q1 and Q2). In the wake of Brexit volatility, central banks in Japan and Europe promised lower rates and, in the case of Japan, greater fiscal easing. The Fed also promised to hold off on raising rates a bit longer. In this environment, the riskiest assets performed the best. However, the combination of record low yields in fixed income markets (normally indicating expectations of weak growth) with high valuations in equities and other risky assets, highlighted a sense of dissonance that prompted open soul searching by policy makers and market participants. In the context of a global resurgence of populist and protectionist policies, a narrative began to develop that we may have had too much of a good thing; for a number of reasons ultra-low interest rates now may be undermining the very stability they seemed to be targeting. In light of this backdrop, Rain portfolios remain cautiously positioned, on both the Growth and Defensive side of portfolios, as we wait for near term political and monetary policy uncertainty to subside.

Central banks reasserted themselves over markets in a big way in Q3, largely responding to the surprise outcome in the British referendum to leave the EU. In the aftermath of the vote, the Bank of England cut interest rates to .25%,

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the European Central Bank promised lower rates for longer, the Bank of Japan extended both its quantitative and qualitative easing programs and expanded its fiscal spending plans, while the Federal Reserve pushed further rate hikes off until November, at the earliest. Yields across global fixed income markets plunged as the new wave of monetary easing took hold. By July, the pool of government debt trading at negative yields grew to $10 trillion. Longer-dated British bonds rallied more than 20% as yields dropped, matching returns more expected from equity markets.

In the short run, ultra-low rates seem good. They successfully stabilized markets, drove volatility back down to earth, encourage investment, promote market liquidity, and so on. However, to the extent that long periods of low rates may be promoting anemic income growth, economic hardship, and rising wealth inequality - the very things that are fueling the discontent that we witnessed with Brexit – they may simply be replacing one form of instability with another.

Since the end of WWII, Western developed country capital markets have been supported by a broad policy consensus around free trade, open borders, collective security arrangements, among other things. The recent wave of populism throughout the developed world (including, in our own country from both progressive and conservative corners) seems to take direct aim at those regimes as the primary causes of society's current ills. To the extent that these more isolationist voices prevail, they would likely carry negative economic consequences. More so than at any time in recent memory, because of the extreme possible outcomes, political developments have the potential to pose a major challenge to financial stability going forward. The US, as the biggest champion and beneficiary of globalization, may stand to lose the most.

This reality has gripped policy makers and markets in the wake of the Brexit vote. Markets, on the one hand, having traded sideways for most of Q3, appear stuck in the headlights of the oncoming November 8th US elections. On the other hand, policy makers have given new urgency to promoting growth, economic opportunity, and stable prices.

Stanley Fischer, Vice Chairman of the Fed's Board of Governors, gave an unusually apologetic speech on October 17th where he outlined why rates remain so low and warned of the economic dangers of keeping rates low for such long periods of time. He went as far as to suggest that most of his colleagues at the Fed *really* dislike low interest rates, but view them as necessary to maintain aggregate demand at levels consistent with the Fed's dual (employment and price) mandate. He worried openly that low rates may be driving investors to be taking too much risk, threatening stability in capital markets. Ultimately, however, he punted the problem to political actors who, in his estimation, have not done enough in recent years to promote stimulative fiscal policies.

Just days later, Tony James (COO of famed private equity firm Blackstone), in an article in the Financial Times, amplified Fischer's fiscal argument, but countered that aggregate demand is weak in part *because* of low interest rates. At ultra-low interest rates, companies prefer to invest in capital rather than labor, driving wages down, unemployment up and undercutting the effects of the stimulus. For those who depend on income-producing investments (namely the elderly), low rates pinch incomes and therefore spending. For savers – whether households, businesses or institutions (foundations and endowments) - who invest today for future spending needs, low rates force them to save dramatically more now to make up for future commitments. Furthermore, low rates make it hard for banks to lend profitably, blunting the effect of the typical credit channels of monetary policy. Finally, low rates signal to the world fear on the part of central banks that the economy is weak which, James argues, is also counterproductive.

Whether for good reason or from pure fatigue, central bankers seem to be losing the argument that low rates are an effect, not a cause, of the anemic growth and inequality that may be fueling populist sentiments. Our perception, as we suggested in our last communication, is that central banks are in fact reaching the limits of their policy options – both for lack of other options and, increasingly, for lack of public support. Furthermore, there is no empirical evidence that very small changes in interest rates have any measurable or sustained effect on the real economy. Moreover, every recovery comes with it uncertainty and fluctuations in economic news that drive markets from one place to another; one day optimism reigns and the next worries prevail that the economy will slip back into recession. Such dynamics can always be used to justify keeping policy rates near zero.

We view the growing consensus that low rates may be creating instability (both political and economic) elsewhere in the system as an important driver of policy going forward. It is happening in the context of asset prices that in many cases don't reflect their underlying risks as well as in a political environment that is increasingly urgent. Central banks are keenly aware that more extreme political outcomes could lead to increased isolationism with repercussions for growth and financial stability. As we discussed in our last communication, the Fed has increasingly used non-data dependent reasons to postpone rate hikes. Now, it seems, external events may be holding them to their original promises.

Portfolio Update:

The low volatility strategies we have used on the Growth side portfolios have outpaced the market this year, but not by enough to offset the lower weight to duration (interest rate risk) we have in portfolios. That's a risk we have been willing to take in this market. Interest rate sensitive assets are increasingly richly priced given how low rates are. Meanwhile, equity valuations appear stretched in certain areas, particularly in the face of flagging earnings reports. To the extent that equity valuations are increasingly supported by low yields, we would view a hike in rates as potentially detrimental to both equities and bonds, hence, our more defensive positioning on both sides of the portfolio. We look forward to reduced policy uncertainty following US elections in November and an anticipated rate hike by the Fed in December, when we believe we will have a number of opportunities to begin adding to positions again.

As always, we welcome your comments and questions.

Your Rain Capital Team,

David, Chris, Ellen, John, Wendy and Jamie