July 2020 – A New World for Interest Rates

With regards to policy, very low real rates can be expected to become a permanent and protracted monetary policy problem.
-Paul Schmelzing, Yale University economist

We all have had our daily lives affected by the coronavirus. As cases continue to spread this summer, it is important to stay safe as the battle is not yet over. We are very thankful to be able to work with you during this extraordinary time.

The Fed's Influence on Fixed Income

During the market turmoil in March and April, our government implemented several relief programs. The CARES Act passed by Congress provided almost $3 trillion that funded many small businesses, hospitals, airlines, hotels and expanded unemployment insurance. In addition to the CARES Act, the Federal Reserve (Fed) and the US Treasury have committed trillions of dollars of liquidity to ensure that financial and credit markets continue functioning. Along with these measures, the Fed has lowered interest rates to zero for the second time this decade.

Historically, investors have had an allocation to fixed-income securities to meet their investment goals. Such securities provide support during stock market downturns. However, in recent years, extremely low and negative interest rates in some countries have driven up the value of fixed-income securities, potentially limiting further appreciation. In fact, despite all the actions taken, the Fed has not been successful at raising rates and normalizing inflation to its 2% target. We should always remember that very low interest rates make stocks more attractive.

Allocation to fixed income should be looked upon as a portfolio stabilizer that acts as a ballast against volatility in the equity markets. Such securities also are a source of income, but unfortunately because of the very low rates, they are not providing much income. This should be the case for the near and intermediate term.

Looking Ahead: Stocks vs. Bonds

In this environment, stocks may give us higher yields. If we buy the S&P 500 today we will earn around 2% in dividends, surpassing what we can find in fixed income, except for bonds with unacceptable credit risk.

We can invest in quality companies that are paying dividends and have been paying and increasing those dividends for decades. When planning for our long-term future, a dividend-paying stock may provide the income we need while current fixed-income yields may not. We look for companies that have the financial stability and cash flow to navigate through this period. Indeed, some companies are emerging stronger as this crisis unfolds.

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Stocks also give our portfolio some protection against inflation, contrasting with the harmful effect inflation has on fixed-income investments. While bond returns would be eroded in an inflationary environment, stock prices may benefit as corporate earnings increase with overall price levels. We can't predict if and when inflation returns, but owning stocks over bonds can help better prepare us for that possibility.

We believe investing is about the amount of time in the market, not about timing the market. As the professor and author Jeremey Siegel points out, U.S. stocks have never been down over any 15-year period, and over any 10-year period, stocks have been up 93% of the time.

A fixed income allocation adds diversity to portfolios and achieves capital preservation. Our natural reaction to the volatility of the last two quarters may be to pursue more of that now. However, there are no free lunches, and we should be mindful of this new environment and its unique risk/reward prospects in the coming years.

These last few months have been a remarkable period. We wish to thank you for allowing us to serve you and help you achieve your financial goals.

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