CRAWFORD INVESTMENT COUNSEL Est. 1980

ECONOMIC & MARKET UPDATE

Both stocks and bonds concluded a very strong first half of the year. Stocks continued their rebound from the decline during the fourth quarter of last year, responding favorably to the message from the Federal Reserve (Fed) that reductions in the federal funds rate are almost surely on the way. Bonds have benefited from the same, as yields have declined sharply since year-end, enhancing bond values. All in all, we believe it was one of the better first-half performances by the financial markets in quite some time.

> "Low interest rates are real and they're here to stay."
> John C. Williams, President of the Federal Reserve Bank of New York

We produce this quote from John Williams since the topic of interest rates is front and center in the minds of investors today. As noted, interest rates have dropped in fairly dramatic fashion with the yield on the benchmark ten-year U.S. Treasury note now down to around 2%, and the Fed appears to be on the verge of reducing rates for the first time in ten years. Over the short term, fears of the effect of trade wars, slowing growth, negative interest rates in foreign markets, and declining inflation have contributed to the drop in interest rates this year. However, it is in a longer-term context that we consider the issue of interest rates and how they are being influenced by secular or structural elements within the economy. We quote Mr. Williams because he is not only a voting member of the Open Market Committee and therefore has an impact on what the Fed does, but also because he has done extensive academic work on fundamental factors that have been and are influencing the longer-term trend in interest rates.

Mr. Williams' statement is a strong one. He states the obvious that interest rates are low but then asserts that they are going to stay low for a long time. We tend to agree with his assertion and introduce this topic as one of the more important factors in understanding the economic and investment world we live in. Many who have been following the economy for more than a few years find it hard to believe that interest rates are so low, not to mention that they are likely to stay low. Let's take a look at some of the factors that have brought us to this state of affairs.

THE NEUTRAL RATE There is an unobservable rate of interest that is consistent with stable macroeconomic performance, that is, it is neither high enough to retard economic growth nor low enough to give a boost to the economy; hence, it is called "neutral," and it is the result of longer-term economic factors. Because it is unobservable and the result of many macroeconomic factors over longer periods of time, identification of the rate is difficult and subject to uncertainty. Nevertheless, understanding where the neutral rate lies is important in attempting to properly view the state of the economy and to predict future trends.

Although all economists do not agree, there is a general consensus that the neutral rate is around 2% - 2.5%, or 0.5% in real terms (after inflation). Furthermore, the rate seems to have dropped by a full 3% over the last generation. Mr. Williams' belief that interest rates will stay low is attributable to the fact that the neutral rate moves very slowly because it is formed by such long-term trends. If one accepts that the neutral rate is low, the implication is that interest rates as we know them, while they may fluctuate around the neutral rate, are not likely to diverge dramatically. We will highlight three of the more important trends that have been exerting downward pressure on the neutral rate. The intransigency of these trends will illustrate again the downward trajectory and also why the neutral rate is likely to stay low. If the neutral rate is low, interest rates will stay low.

Demographics It is a fact that, globally, people are generally living longer, and population growth is slowing. In developed countries, population growth averaged near 1% in the middle of the last century, but now it is running at around half of that. By 2050, the United Nations estimates that global populations will be shrinking. This is a fundamental problem for the outlook for savings and investment, the two factors that most heavily influence interest rate moves over time. With population growth decelerating and life expectancy increasing, the average length of retirement is now nearly twice what it was in the 1970s. People living longer is obviously a positive trend in human terms, but it carries significant implications for life-cycle budgeting, and it implies a surplus of savings versus investment. Greater savings and less investment suggest lower interest rates. Demographics don't lie and they change very slowly, so this factor will continue to exert downward pressure on interest rates.

Demassification Larry Summers, former Treasury Secretary and prominent economist, coined this term to describe a major change in our economy. It refers to the transition from "hard" to "soft" investments, most of which are less costly. This demassification can be seen in the effect, for instance, of Airbnb on the hotel industry. Because people are using private homes for travel, we need fewer hotels which means less investment spending. The same is true for e-commerce and its effect on shopping mall construction. Companies are increasingly budgeting for software and other technologies rather than more expensive capital investments in plants and buildings. All of these developments point toward less investment, which means more savings. Again, the surplus of savings over investment means a push toward lower interest rates.

Income and Wealth Inequality In recent years it has become generally accepted that income and wealth inequality not only exists but is an important economic issue. There are many dimensions of this issue, but we focus on the one that has implications for lower interest rates. Again, it has to do with savings and investment, which of course has to do with overall economic demand. Investment creates demand; savings do not. Simply stated, very large percentages of total wealth are concentrated in the hands of relatively few. From a demand standpoint, the wealthy are so wealthy that they can only spend a small portion of their wealth, thus they save a disproportionate amount. This propensity to save rather than consume impacts overall demand, producing, in turn, slower growth and the tendency toward lower interest rates. Like demographics, income and wealth inequality is a problem that cannot be fixed quickly, so its influence on interest rates looks to be enduring at this point.

There are other factors that are also pushing downward on interest rates, but suffice it to say, the three we mention are powerful long-term trends and are, in our view, unlikely to change anytime soon. If they are conspiring to push the neutral rate lower, then nominal interest rates as we know them are also likely to stay low. It is the intractable nature of these trends that forces the conclusion that interest rates are likely to stay low for the foreseeable future. This does not mean that on a temporary or cyclical basis we cannot get upswings in interest rates to a moderate degree, but a major turnaround toward sustained higher rates does not look likely. At the very least, the factors we have discussed will create a lower ceiling on interest rates compared to previous cycles. In our opinion, low interest rates are a feature of the world we live in and, as investors, we need to get used to them.

INVESTMENT IMPLICATIONS If, in fact, low interest rates are here to stay, what does this mean for the outlook for returns from stocks and bonds? Generally speaking, low interest rates are a positive for both stocks and bonds, although there are qualifications. For stocks, to the extent that low interest rates suggest lower overall economic growth, this potentially limits the ability of companies to increase their earnings at attractive rates. Normally, this would be considered a negative. However, as companies have demonstrated in recent years, they have been able to provide attractive earnings growth in the face of slower economic growth because of the positive impact of lower interest rates and inflation. For instance, low inflation has facilitated forward planning, and low interest rates have enabled attractive financing of projects. Furthermore, a low interest rate means discounting future earnings and dividends at a more attractive rate, thus suggesting the possibility of higher price-to-earnings ratios.

The implications for bond investors are both good and bad. The good news is that if interest rates stay low it means that impairment of bond values from rising rates is not likely to happen, resulting in more predictable returns. On the other hand, the fact that yields are low means lower income from bond investments. But, to the extent that bonds are held in balanced portfolios, the ability to protect overall portfolio values in a downturn for stocks is not diminished. We still prefer bonds as the best diversifier of equity risk.

Investing successfully over the longer term requires both consistency and flexibility. We continue to believe that long-term investing is the best way to accumulate and maintain wealth. And quality will remain as the central ingredient in our investment approach. But the world changes, and one of the more dramatic changes over recent decades has been the change in interest rates. We present this discussion in an effort to explain why the change has occurred and why it is likely to be a more permanent fixture of the economic landscape. It is important to understand the world we live in, and low interest rates are a significant part of that world.