Quarterly Commentary

PACIFICA PARTNERS INC.
Capital Management

Low Interest Rates - a Fading Solution

This quarter's newsletter aims to take a look at the economic prospects of North America, Europe and Asia – specifically China and Japan. The last several months have served as a reminder to the global financial markets that the work of central banks is not done yet. Nearly six years after the last recession ended the world finds itself still guessing as to when interest rates will finally begin to rise. As Europe is so clearly illustrating, central bank easy money policies that have kept rates at generational lows have limits to their effectiveness.

The way the world has emerged from the financial crisis is significantly different than that which was imagined in the aftermath of the financial crisis in early 2009. The conventional logic was that the generosity of central banks' easy money policies would eventually usher in inflation and then in turn higher interest rates. Instead, economists are busy taking out their erasers and bringing down their estimates for economic growth and with it the likelihood of any immediate rise in rates.

In the last few months of 2014, the International Monetary Fund (IMF) announced that there had been a widespread loss of momentum in economic output across most economies. To this end, the IMF has cut its estimate of global economic growth from 3.4% to about 3%. Only a few months prior, the expectations were for 3.6% in annual growth – faster than the long-term global average.

In This Issue:

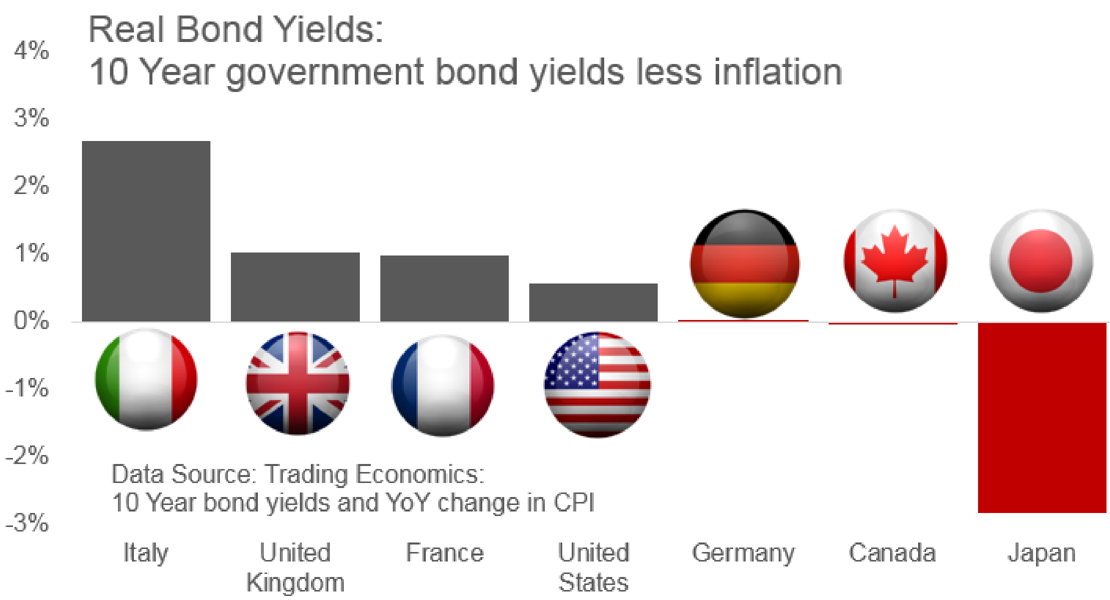
- Over the last six years economic growth has come about on the back of a low-interest rate environment .
- The benefits of "easy money" central bank policies is now starting to wane.
- Systemic economic weakness exists across the globe which can only be overcome by structural reforms.

Unfortunately, low interest rates provided only a temporary boost to the economy which is now fading. Furthermore, according to economist Eswar Prasad of the Brookings Institution,"… aggressive monetary policy actions has not been used well by most major economies". He goes on to state that the opportunities that the low interest rate environment provided to stabilize economies, should have gone hand-in-hand with economic reforms, but those opportunities have been "squandered".

With sub-par domestic demand, exports are the only route of escape from economic malaise. As a result, every nation is posturing to ensure its currency remains grounded relative to that of its trading partners. This serves to keep exports cheap and attractive to foreign buyers. Unfortunately, if every country is betting on a cheap currency to spur export led economic growth, something has to give. Every nation cannot be a winner from currency devaluation.

North America: CANADA

Starting with Canada, markets are beginning to get used to the idea that it will be some time yet before Canada is in a position to even consider raising interest rates. The Governor of the Bank of Canada, Stephen Poloz has been vocal in expressing his disappointment in Canada's recovery. In addition, he is concerned about high Canadian debt levels – especially at the household level (i.e. mortgage and credit card debt). The Senior Deputy Governor, Carolyn Wilkins recently characterized the Canadian economy as "underwhelming". In addition, wage growth has been slower than usual. Economists point to the fact that wages have risen at only a 2.1% annual rate while historical precedent suggests that, given where the unemployment rate is, they should be growing at just over 3% annually.



Markets are continuing to bet that the Bank of Canada will hold off on raising interest rates at least until early 2016. The central bank finds itself in somewhat of a quandary as it is balancing the needs of the economy and a real estate market that is seen by the IMF as possessing risks to the economic outlook for Canada. Recently, US bond rating agency Moody's has also chimed in with its concerns that Canada's "particularly inflated" housing market poses a risk to the Canadian economy. Though it maintained the AAA credit rating for Canadian government debt, the company said high consumer debt and real estate prices pose "a potential risk to the banks and to the federal government".

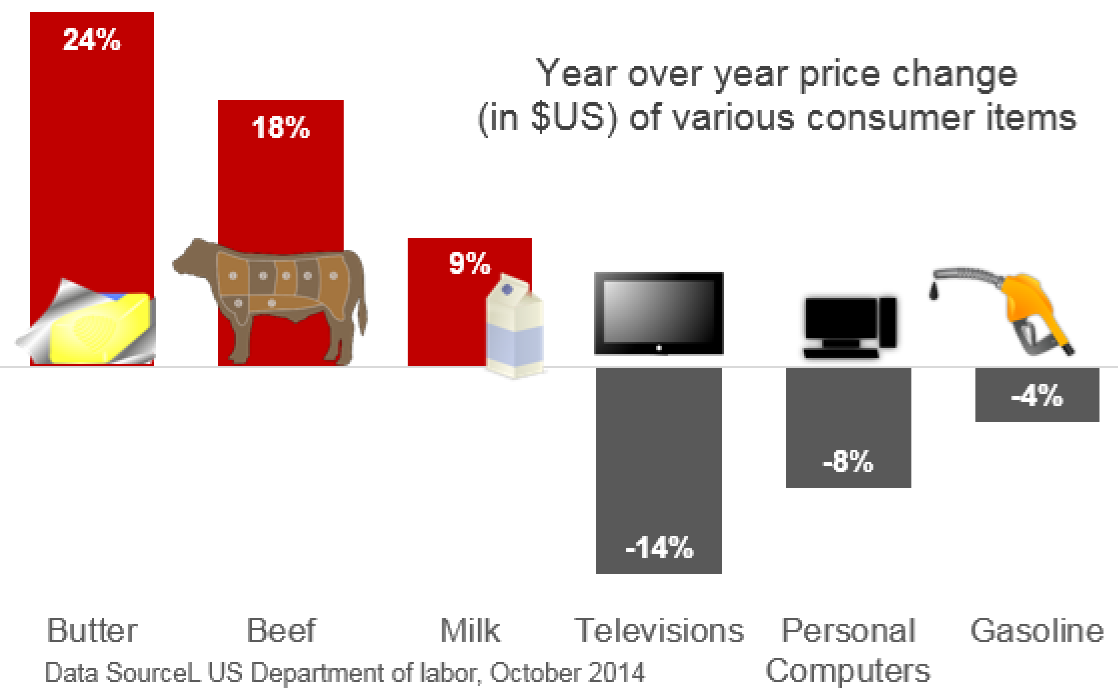
UNITED STATES

The US economy is the lone bright light these days, having resumed its traditional role as the leading engine of growth.—but an engine that is not running on all cylinders. While consumer confidence has risen to its highest levels in years and wages have begun to stabilize, the mood of the country seems to be one more in line with a nation that is still trying to shake off the cobwebs of the last recession.

Part of this stems from the global problem of stagnant wages. Even with low inflation, consumers and households are feeling the effect of paycheques that are not growing fast enough and rising food prices that are offsetting price declines elsewhere. As we laid out the case in our previous newsletter, rising food prices could persist for some time due to climate and water resource allocation issues. In the most recent inflation report from the US Labor Department, the consumer price index (CPI) showed only a 1.7% y-o-y increase in inflation but food prices rose considerably more. As the next chart shows, food prices are about the only source of any inflation pressure. It is worth noting, however, that food prices are rising due to climate change—not central bank policies.

According to the latest economic forecast of TD Economics, the US economy is expected to grow at a 2.2% annual rate this year and 3.0% next year. The key driver for sustaining this economic growth will be a pick-up in capital expenditures (i.e. investment by business and government in plant, property and equipment). As we highlighted in our Spring 2014 newsletter ("An Embarrassment of Riches"), capital expenditures by business and government will need to increase to get the economy on a self-sustaining path. To some extent, this has begun as businesses have indicated that they are finally ready to invest. This is evident through the stock piling of more than $3.6 trillion in cash and borrowing of $1.28 trillion that S&P 500 companies have undertaken.

Up to this point in the economic recovery, US companies have focused on stock buybacks and dividend payments to shareholders as their priority instead of investing in future growth. In the most recent quarter, S&P 500 member companies spent $230 billion in dividends and stock buybacks but earned only $235 billion. Likely we are reaching the saturation point for stock buybacks as a source of support for the market.



Governments at the state and municipal levels have also begun to increase spending once again as tax revenues have increased in response to the slow but steady growth in the economy. This will help economic growth in time.

Going forward, it is difficult to mathematically make the case for dramatically higher equity prices from here without some pick up in economic growth. Revenue growth and economic growth go hand in hand and without revenue growth, earnings growth becomes a challenge.

Asia: JAPAN

Perhaps out of desperation, Japan has thrown caution to the wind and is taking some of the boldest action yet on the monetary policy front by being unequivocal about its commitment to drive interest rates even lower from their minimalist levels of the last nearly two decades. But more importantly, Japanese Prime Minister Shinzo Abe finds his economic reform program known as ***Abenomics*** is beginning to lose some steam. His program is said to have three arrows – two of which have been implemented (a multi billion spending stimulus program and a mandate for the Bank of Japan to generate 2% annual inflation through a QE program similar to the US version). While these have been implemented, Abe has found the "third arrow" of structural reform more difficult to implement. His experience in this regard is no different than many other world leaders.

CHINA

Perhaps the country with the boldest initiatives in implementing structural reforms has been China. The Chinese government has begun to take measures to clamp down on excessive bank lending, reduce the economy's reliance on construction & real estate and shutting down excess capacity in various industries. Over time, the Chinese government would like its economy to become more consumption driven – rather than one that relies on exports and cheap and abundant credit. However, time will tell if the Chinese government is able to stick to its reform path if its economic growth begins to slow down. The government has maintained all along this year that it will be able to hit is 7.5% economic growth target. Some economists are skeptical of this number as Chinese economic data is thought to be of a somewhat suspect quality. Even Chinese Premier Li Keqiang has called China's GDP figures "man-made" and unreliable.

EUROPE

The head of the European Central Bank (ECB), Mario Draghi, has been clear in his defense of his central bank policies and the lack of concrete economic momentum they have generated. Economists have long maintained that European leaders need to implement a stimulus program, targeted tax cuts and a regulatory relaxation. This is not lost on European politicians as can be seen by the comments of incoming European Commission President Jean-Claude Juncker when he said recently that **"Citizens are losing faith. Extremists on the left and right are nipping at our heels. …. It is time we breathed a new lease of life into the European project."**

Currently, the European Central Bank has pulled out all the stops it can muster. In Germany, two year government bonds are yielding a negative interest rate. A negative interest rate implies a world in which money is borrowed and the borrower has to pay back less than the original amount borrowed. Such is the state of Europe.

The Way Forward

If there is one thing that should be clear by now, it is that low interest rates can only go so far. The global economy is fast reaching the limits of the benefits of ultra low interest rates. The missing ingredient is structural reform. This can only be achieved by serious reform efforts in North America, Europe and Asia. Whether it is tax reform in the US, labor and regulatory reform in Europe or the removal of trade, investment and immigration barriers in Asia – the global economy is in need of strong leadership that will allow it to throw away the crutch of low interest rates.

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