



## INVESTING IN A ZIRP WORLD

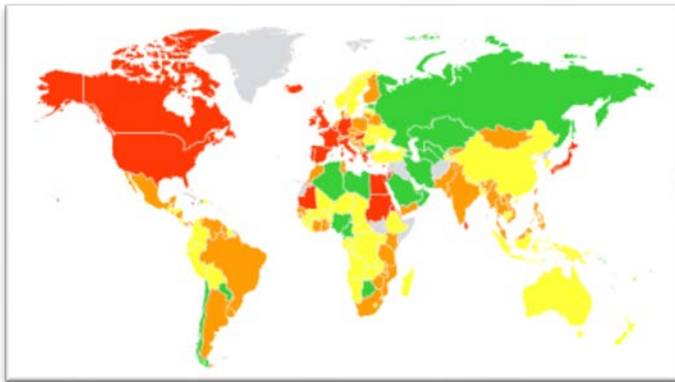
|                                       |   |
|---------------------------------------|---|
| Investing In A Zirp & QE World.....   | 1 |
| Effects On Growth And Inflation ..... | 2 |
| Effects On Asset Prices.....          | 3 |
| Opportunities .....                   | 4 |
| Risks.....                            | 6 |
| Gold.....                             | 7 |

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## INVESTING IN A ZIRP & QE WORLD

Central banks in several of the major global economies have been running a ZIRP (zero interest rate policy) for years and this has had a major impact on returns and risks for investors. The US, UK, Japanese and European Central banks have also pursued a policy of QE (quantitative easing) which has substantially altered the balance sheets of central banks, financial institutions, private individuals and corporations around the world. The combined effect on asset prices and their volatility has been substantial. The effect of QE on growth and inflation is less convincing.



Debt/GDP: Red (>75%), Orange (40-75%), Yellow (20-40%), Green (0-20%)

Source IMF

We will be looking at these aspects in more detail throughout this report.

QE swelled the Fed's balance sheet from about \$870 billion in 2007 to \$4.5 trillion today. The Bank of England has printed a total of £375 billion. The Bank of Japan's balance sheet has expanded from \$1 trillion in 2007 to \$3 trillion in 2015.

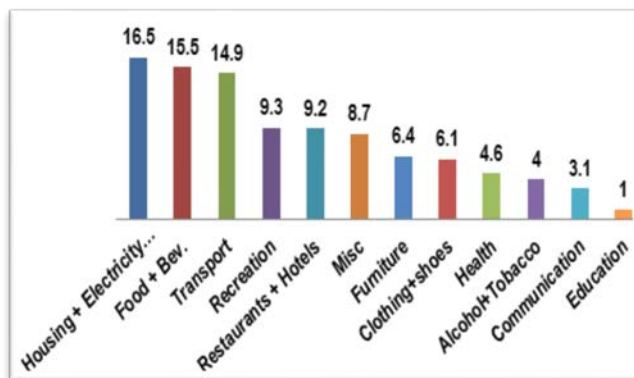
The ECB launched a EUR 1 trillion QE programme in March this year. By September 2016 the ECB balance sheet is expected to reach \$3.5 trillion from a level of \$1.9 trillion in 2007. While all of the above mentioned central banks have launched QE to purchase bonds in their own currencies, the Swiss National Bank (SNB) printed vast amounts of Swiss Francs in order to buy large amounts of bonds in foreign currency in an attempt to weaken the Swiss Franc. The SNB terminated this programme in January 2015. However, it launched a negative interest rate policy in an attempt to make the Swiss Franc less attractive to foreign investors.

As a result of ZIRP + QE most central banks are now saddled with very stretched balance sheets and Governments are over indebted. Any rise in interest rates would cause losses for central banks and budget deficits which could exceed the agreed allowable maximums. Most central banks are convinced that they can gradually shrink their balance sheets as economies recover. Governments believe that they can do the same with budget deficits and debt to GDP ratios. However, these goals could prove hard to reach as both growth and inflation are lagging the required targets.

## EFFECTS ON GROWTH AND INFLATION

The jury is still out on how much QE helps growth and wards off deflation. Buying government bonds has done very little to increase capital flow to small and medium sized companies struggling to stay afloat and retain employees. Even though banks are being penalised for holding cash in their central bank reserve accounts, regulation is prescribing what assets banks can hold and how much capital they need which is preventing a healthy resumption of lending. Large companies are suffering from over capacity and have little incentive to invest even at historically low interest rates. Consumers plagued by worries about their jobs and finances tend to save more than they used to. All of this leads to sub par growth even seven years after the crisis.

Though there have been signs of growth in the US, UK and most recently Europe, inflation has fallen well below the 2% target set by most governments. Growth is still substantially lagging the



trajectory of past recoveries. As long as the velocity of money remains subdued due to banks hoarding cash, corporations delaying investment and households increasing savings, headline inflation should remain subdued and the inflationary effects of QE should remain benign. I must emphasise headline inflation as most people

have already noticed the increase in housing, healthcare/insurance and education costs. All of these are running way ahead of the 2% inflation target. For most households, these three items make up about 30-40% of total expenditure, however their weight in the inflation basket is not significant enough to move the needle. Governments are pursuing both growth and inflation targets with great determination. Our concern is that when inflation does rise toward their generally desired target of 2%, it will prove as difficult to control as deflationary forces are at the moment, due to all the QE in the system. When growth appears to be recovering governments end QE and start considering interest rate rises. The pace of rate rises is usually very gradual in order to avoid de-railing growth. As growth improves, banks, corporations and households might start to lend, spend or invest simultaneously. As a result, the velocity of money which has been extremely low could rise rapidly and central banks may find themselves well behind the curve when it comes to limiting inflation to their desired 2%. Therefore, it is possible that due to the volumes of liquidity created by years of ZIRP and QE we turn very rapidly and unexpectedly from a deflationary threat to an inflationary spike.

## EFFECTS ON ASSET PRICES

QE+ZIRP was intended to stimulate growth and ward off inflation in the real economy. Instead of being invested or spent in the real economy, liquidity is being pumped into the financial markets and has caused asset price inflation and a marked increase in volatility.

Pension funds and insurance companies are forced by regulations to hold the bulk of their assets in money market funds or high quality bonds. They have been forced into government and other high grade bonds as money markets are not viable in a ZIRP environment. As a result, the short end of the euro government bond yield curve and in Switzerland even the 10 year bond have a negative yield! Investors who can accept more credit risk have been increasing their holdings in high yield bonds and this has resulted in historically tight spreads and high prices. The volatility of these bonds approaches that of equities and in times of turbulence, they do not fulfil the traditional role of bonds for investors.

In the past, most investors opted for a balanced portfolio, allocating approximately half their assets to bonds and half to equities. In the last decade, gold, commodities, alternative investments, hedge funds and private equity have been added but the broad allocations to risk remained quite stable. Whenever the equity market hit a rocky patch, the high grade bonds in investor portfolios provided stability, reducing volatility and supplying income. This role of reducing volatility and providing income has been eroded in the ZIRP+QE environment. Not only do high quality bonds provide little or no income, they are more volatile than most investors are used to. As a result total return expectations of portfolios have dropped while volatility has risen.

Some investors have increased their allocations to equities, with stable dividend yields. These investors are buying high dividend equities as a source of income because bonds do not provide enough income anymore. However, they are not used to the volatility of equities and tend to panic sell in times of temporary turbulence. This behaviour diminishes returns and increases volatility.

Hedge funds and other market participants working with leverage are much more prevalent in a ZIRP+QE environment as borrowing is cheap. This increased leverage causes very exaggerated market moves. The leverage is used in rising markets to multiply returns. However, if markets start to drop, leveraged investors are unable to wait for markets to stabilise as they are working with borrowed money and need to sell before their losses pile up. As they bid the market up with leverage and then exit with leverage, moves in both directions are amplified.

## OPPORTUNITIES

Our clients will recall that when there was a general reluctance to buy European equities in 2012 we were gradually increasing exposure to good quality companies with high dividend yields. These equities have done extremely well over the past three years. At the time we made the decision, valuations of such companies were low and even though we felt this was unjustified the terrible volatility in European equity markets in 2011 had dissuaded most investors from increasing exposure to equities.

We have been looking at various asset classes, regions and sectors for similar opportunities. What we have noticed is the following:



- Investors have moved large parts of their bond allocation to high yield bonds as investment grade bonds yields have dropped towards zero.
- There is a tendency to favour high yield bonds over equities in good quality cyclical companies even though volatility is similar.
- Gold which was highly sought after till 2011 is completely out of favour.
- Prices of several industrial commodities and oil are at levels last seen in the depths of the financial crisis.

Considering all that has happened since the financial crisis there are three possible scenarios we currently consider when making decisions about asset allocation.

1. **Moderate Improvement - in our opinion the mostly likely scenario:** The Chinese manage to support growth using targeted stimulus and in the US and Europe growth and inflation gradually move towards the preferred targets. The Chinese have gained admission into the SDR (Special Drawing Rights). They now need to keep growth on track in order to maintain their citizens confidence in the government. We therefore believe that they will do everything possible to achieve their growth targets. They have been increasing stimulus measures and supporting capital flow and these measures should begin to bear fruit shortly. We believe that as signs of stability emerge, markets will turn their attention to the support lent by QE in Europe and the very slow rise in US interest rates. The FED has made the first move this year and forecasts rates to rise to about 1.5% by the end of 2016. The fear of losses that market participants now focus on could then rapidly change to opportunity seeking. As bonds offer very little in the form of yields at the moment, the equity market should be the beneficiary. We think that the whole commodity complex will benefit in this environment and sectors that have been severely punished such as energy, materials and industrials should benefit the most in terms of appreciation from current levels. We believe that marginal allocations will be diverted from high yield bonds to equities. In this scenario, beaten down commodity currencies should reverse some of their losses over the past year. Gold prices should rise even if the US is increasing rates gradually as negative real interest rates should prevail. We believe that, as interest rates remain low in the US and near zero in Europe, the opportunity cost of holding a zero yield asset like gold is negligible. It therefore makes sense to hold gold as a diversification in the context of all the past and on going QE.

2. **Deflation & Loss Of Confidence:** It is in our opinion less likely that we should see a deflationary environment but it cannot be ruled out completely. In this scenario, equities, especially the cyclical sectors which are already beaten down would suffer further. In general equities markets would sell off and bonds, gold and cash would be the assets of choice to preserve wealth even if returns are negligible. If deflation is accompanied by a lack of confidence in governments and central banks to remedy the situation, gold should be the best performing of the three assets. Gold tends to do well during periods when confidence in the system is low. This was seen in 2008 and again in 2011. Though government bonds could act as a safe haven, high yield bonds could lose as much as equities in this environment. We believe that as governments and central banks are acutely aware of the dangers of a deflationary cycle and do not want to run the risk of having provided all the stimulus so far with no result, they will do everything in their power to avoid this situation. This of course does not mean they are guaranteed to succeed.
3. **Inflation Exceeding Targets:** The third possibility, which is one that is being given very little attention by market participants, is that of inflation rising to levels above the generally preferred 2%. This would put pressure on governments to raise interest rates. In this scenario the biggest losses would be in bonds, especially those issued by companies with less than sound balance sheets as rising rates would threaten credit ratings. When inflation is due to pent up demand for consumption and investment rising faster than expected, equities should do well as long as inflation remains contained even if it exceeds the 2% level. The energy, material and industrial sectors would be the major beneficiaries in this scenario. Gold would also gain if, as we expect, central banks are lagging with their interest rate rises and real rates remain negative. Attention would also then turn to the negative effects of QE on the value/purchasing power of cash and benefit gold further.

## Risks

We believe that the current environment must be approached with care. If the governments and central banks underestimate the current situation or fail to adequately address the threat of deflation, a substantial loss of confidence would lead to large drops in equities and high yield bonds. There is also the possibility that Greek debt unsustainability returns to focus. There could be other sources of turbulence such as Russia/Ukraine/Syria, or something yet unforeseen. If at the time growth and inflation in the rest of the world are on track, this would cause just a temporary setback in financial markets. However, if this happens while deflation is still a threat, the danger of escalation would be high and lead to a spike in volatility.

As mentioned earlier, the rally in financial asset prices has been driven to a large extent by ZIRP+QE. These monetary policies drove large volumes of liquidity into the financial markets instead of the real economy. There has not been enough fiscal reform to encourage spending and investment. As the incentives to invest were not as great as the incentive to borrow at low rates and buy back shares, many companies have done the latter, further supporting share prices. For companies with solid balance sheets, such decisions seem logical. However, due to the low interest rate environment many companies with low credit ratings have managed to issue bonds at relatively low yields. These are highly leverage companies with volatile earnings streams. One example would be oil and gas exploration companies in the US. They have issued bonds to invest in exploration and are highly dependant on cash flows from the sale of oil and gas. Recently many of them have experienced great difficulty due to the low commodity prices and in some cases profits have dried up completely. Their ability to pay interest due and return capital depends on the profits and free cash flows which have almost vanished recently. Their bondholders run the risk of never receiving the paper returns they were expecting.

Hedge funds have been able to borrow at very low interest rates and make better returns using large amounts of leverage. Many of them base their positions on algorithms and high frequency trading. As a considerable amount of leverage is involved, losses can pile up quickly, so the funds operate with tight stop losses which trigger sales when losses breach their limits. If several funds are operating on the same principal, the repercussions can be severe. This type of trading has already caused excessive volatility and exaggerated market moves in both directions.

## GOLD

Gold has been viewed as an asset class since the launch of the gold ETF in the US ten years ago. However, its traditional role as a store of value/money has faded as fiat currencies are now considered money and used as a medium of exchange. Investors view gold as a



diversification in portfolios. However, it could also be viewed as an alternative currency. There has been talk of returning to the gold standard in order to control such rampant money printing. Whether this is a viable possibility or will ever happen is up for discussion. But the suggestion itself puts forth the

question of the role of gold and how it should be viewed in the context of QE.

Let us look at the generally accepted, main requirements for money:

1. Durability: Given technological advances and replacement of old bills on a regular basis, one could conclude that both gold & fiat money fulfil this requirement.
2. Portability: Both Gold and fiat money fulfil this requirement.
3. Divisibility: Both Gold and fiat money fulfil this requirement.
4. Uniformity: Both Gold and fiat money fulfil this requirement.
5. Acceptability: Both Gold and fiat money fulfil this requirement.
6. Limited supply: Due to QE Fiat currencies do not fulfil this requirement.

To quote the website of the Federal Reserve Bank of St. Louis "In order to maintain its value, money must have a limited supply". "The supply, and therefore the value, of money in general is regulated by the Federal Reserve so that the money retains its value over time".

The FED agrees that money supply should not be expanded at will and that if it does happen, its value will diminish. The FED is having extreme difficulty implementing an interest raise rise



from a level of 0% and there is absolutely no talk of withdrawing any part of the existing QE. In fact there are calls by some for more stimulus! The supply of money has been increasing by 10-20% per year since the crisis and the supply of gold by 1.5% per year. This should imply a much higher gold price if

gold is viewed as an alternate form of money.

In the past, the price of gold has been influenced negatively by strength in the US dollar or relative strength of the US economy and positively if real interest rates were negative (inflation > interest rates). The following are some of the most mentioned justifications for the movement of the price of gold:

- Gold is traded mainly in US dollars, so a weaker dollar makes gold less expensive for other nations to purchase, this should increase demand and therefore price. As the dollar is still the worlds reserve country and the most widely held of all currencies, when the dollar starts to lose value, investors look for an alternative store of value such as gold.

- Gold's value also fluctuates as a result of the strength of the US economy. The revival of the US economy would imply higher interest rates in the future. Higher interest rates increase the opportunity cost of holding zero-yield assets (gold); the money tied up in bullion could be earning a return if invested in treasury bills or other debt. Strong corporate earnings have a similar effect; when dividends are generous, it hurts to miss out on them.
- However, even if interest rates are rising, real interest rates may still be negative. This would happen if the nominal interest rate is below that of inflation. Gold usually fares well in a low or negative real interest environment. The opportunity cost of holding gold versus cash or bonds is very low and gold tends to preserve purchasing power when negative real interest rates are eating away at the purchasing power of cash.

Considering all of the above we would recommend holding gold as part of a balanced portfolio.

#### Conclusion

It has been seven years since the financial crisis. Initially in 2008 it was the FED who decided to reflate the US economy by doing all it could in the form of stimulus. Then four years later in 2012, the ECB under the leadership of Mr. Draghi pledged to do "whatever it takes" and has reiterated this message each year. Japan launched their massive stimulus program a few months later. Recently, the Chinese have been implementing various measures to improve growth without much success. Is China reaching its "whatever it takes" moment? If so, deflation would be averted and instead, the possibility of above average inflation would have to be considered.

We hope you have found this report informative and look forward to hearing from you with any feedback or questions.

Gillian Hollenstein