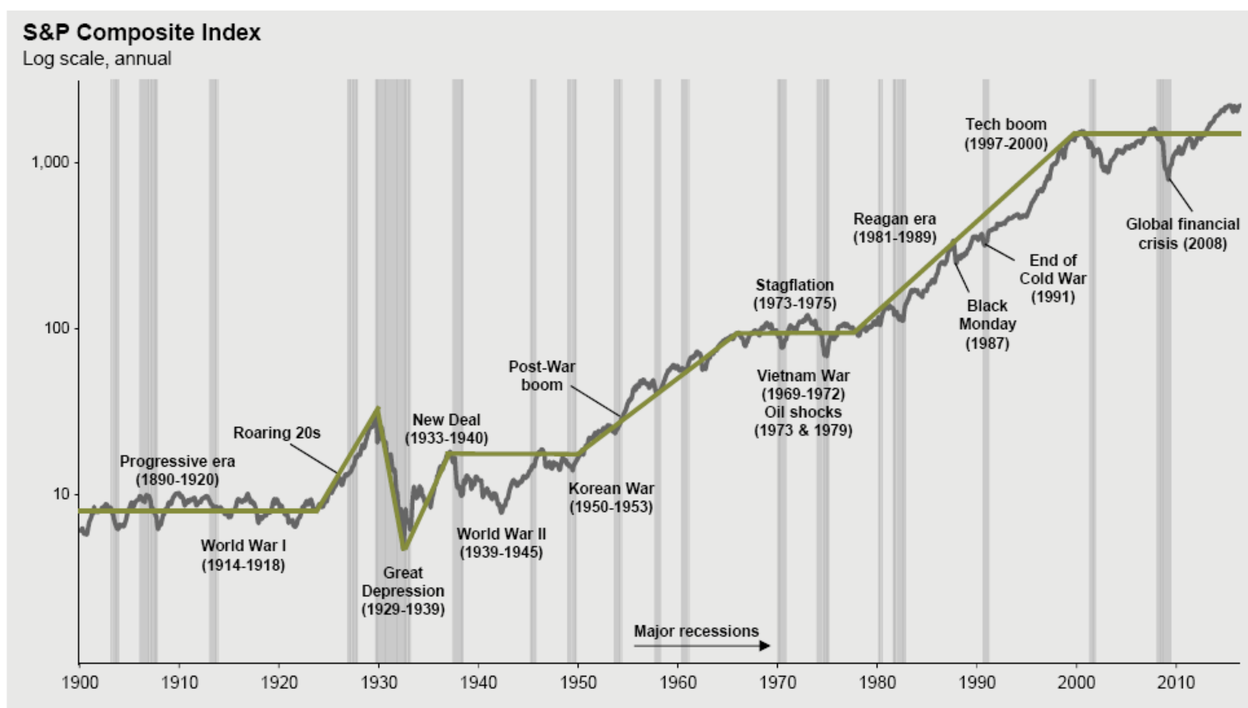
The Challenge Ahead – "Lower for Longer"

While Brexit captured headlines during the quarter, by the end, it was mostly a non-event from an overall market perspective. Brexit's impact is expected to be largely contained in the UK, but it creates more uncertainty for Europe in general. It also means that there is a greater likelihood that we will experience "Lower for Longer."

What does "Lower for Longer" actually mean? The phrase has primarily been used to describe the expected level and trajectory of the interest rate that the US Federal Reserve sets for overnight lending between depository institutions, such as banks and credit unions. The rate is currently holding at 0.38%. However, "Lower for Longer" can also apply to a number of other important financial market conditions – GDP growth, equity and bond returns, and commercial and residential lending rates – that have significant impacts on our lives.

When we look at long term returns, it can feel like we have been in a "Lower for Longer" environment for quite some time. The chart below gives a long term perspective on performance of the S&P 500. Returns have been relatively flat over the past 20 years with considerable volatility. This time period includes the tech bubble/bust and the financial crisis.



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.
Guide to the Markets – U.S. Data are as of June 30, 2016.

The Fed has been trying to raise rates for some time for at least two reasons. First, in the event of another future recessionary period, the Fed wants to maintain its ability to spur growth by lowering rates. This is an important tool in the Fed's toolbox. The problem now is that rates are so low, there is not much room for such maneuvering to spur growth if needed. Second, the Fed wants to ensure that inflation remains in check. The current target is around 2%. While inflation is not an issue now, continuing to spur growth also brings the risk of spurring inflation.

So, here is the Fed's dilemma. Raising rates higher while other countries are still trying to stimulate their economies with lower rates could lead to an influx of overseas money seeking both safety and a better return relative to local sovereign bonds. In fact, over the last couple of years, we experienced significant private foreign investor net flows to US fixed income. This strengthens the US dollar, making US exports more expensive and thus less competitive. This can hurt large US companies with an international presence. The Fed has a real balancing act on its hands with a number of reasons to keep rates low.

Slow Global GDP Growth

Ongoing economic stimuli have been necessary to sustain Europe's slow recovery and promote a modicum of growth in Japan and stem the decline in China. Unemployment is decreasing steadily in Europe, though it is still relatively high at 10.2%. Eurozone and Japanese GDP growth has averaged slightly below 0.65% since 2011. China's GDP growth dropped from 10.6% in 2010 to 6.9% in 2015 and is expected to decline further.

Muted Equity Returns

US equity valuations are a little ahead of long-term averages. This means they are more susceptible to volatility and risk of loss if economic growth falters. Developed international equity valuations are slightly below long-term averages. Emerging market economies have slowed considerably and their valuations are well below average.

Economic stimulus and low interest rates at a fundamental level should be positive for equities. However, when the effectiveness of current stimuli fades and governments are burdened with large amounts of debt, there will be negative consequences for equity markets if a market-based equilibrium cannot be achieved. How the governments in Japan and the Euro-area manage the large debt burden that continues to build, 232.5% and 106.9% of GDP respectively, and how the Chinese government manages the transition to a service-based economy will be critical to finding this equilibrium.

A Challenged Bond Market

Bonds will be challenged for several reasons. As rates rise, longer bonds become more risky (as rates go up, the price of a bond goes down). Also, investors will seek higher yield from other sources to support current income or growth for the future. International fund flows exacerbate currency and bond market volatility.

Some investors are seeking higher yields by taking on more risk in the form of high yield bonds. This can actually reduce the diversification benefit of holding bonds because high yield bonds are more highly correlated to equities. US Treasuries are also more volatile as macro events lead investors to seek the safety of the dollar and higher yield of US Treasuries.

Commercial and Residential Lending Rates

Lower interest rates on commercial real estate loans have facilitated the improvement of personal and corporate financial statements as loans have been refinanced with historically low rates. In many cases, cash flow has improved as a result of lower interest payments. Household debt service ratio is at a very low 10.1% of disposable income. Low interest rates have boosted crippled real estate markets and contributed to record amounts of cash on corporate and personal balance sheets. So, what's the problem? Too much of a good thing can lead to taking on more risk and creates the potential for bubbles.

Lower for Longer: Why should you care?

It will be difficult for individuals and organizations to maintain "safe" spending or distribution levels from portfolios in a low rate/low return environment. Reduced distributions, however, will be mitigated somewhat by low inflation. This is because expenses will also tend to grow slower.

Time to be Selective

Passive investing has become increasingly popular; however, we believe that it is now more important than in recent years to be selective and active managers will earn their fees and more. Below is a chart showing the returns for selected countries and regions in US Dollar (USD) and Local Currency (Local) for 2015 and YTD 2016. Note the wide variability in returns. This illustrates the compelling argument for active management which allows for discretion and discernment in the selection of countries and securities. The chart also shows how the rising dollar hurt international returns in 2015 with a reversal in 2016 (with the exception of the UK) as the dollar fell.

	2016 YTD		2015	
Country / Region	**Local**	**USD**	**Local**	**USD**
Regions / Broad Indexes				
All Country World	0.0	1.6	1.8	-1.8
U.S. (S&P 500)	-	3.8	-	1.4
EAFE	-6.8	-4.0	5.8	-0.4
Europe ex-U.K.	-7.4	-5.3	9.1	0.1
Pacific ex-Japan	0.5	2.5	-0.8	-8.4
Emerging Markets	3.6	6.6	-5.4	-14.6
MSCI: Selected Countries				
United Kingdom	6.9	-3.0	-2.2	-7.5
France	-5.5	-3.3	12.3	0.8
Germany	-9.3	-7.3	10.0	-1.3
Japan	-19.3	-5.4	10.3	9.9
China	-4.4	-4.5	-7.7	-7.6
India	3.2	1.1	-1.6	-6.1
Brazil	18.6	46.5	-12.5	-41.2
Russia	8.3	20.6	22.9	5.0

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
All return values are MSCI Gross Index (official) data. Chart is for illustrative purposes only. Past performance is not indicative of future results. Please see disclosures page for index definitions. Countries included in global correlations include Argentina, South Africa, Japan, UK, Canada, France, Germany, Italy, Australia, Austria, Brazil, China, Colombia, Denmark, Finland, Hong Kong, India, Malaysia, Mexico, Netherlands, New Zealand, Peru, Philippines, Portugal, Korea, Spain, Taiwan, Thailand, Turkey, United States.
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Developed international markets present opportunities with careful security selection because valuations are lower. Emerging markets are likewise undervalued and still more likely to be an engine of growth but it especially pays to be selective in this asset class. The important thing is to make sure you have a reasonable likelihood of being compensated for the risk taken.

"Lower for longer" is certainly not exciting and can be discouraging. With bond markets challenged, it may be tempting to take more risk to get a higher return. This is a time for caution, patience and selectively seeking opportunities when market dislocations occur.