FALL 2019 | VOL. 26 | NO. 4
QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

ARE NEGATIVE INTEREST RATES POSITIVE?

Will Williams *Chairman, President & CEO*

As the third quarter of 2019 has now come and gone, there was probably no subject more discussed in the banking world than the prospect of the U.S. Federal Reserve pursuing a negative interest rate monetary policy. Hard to fathom that the world's largest economy would have to go to that extreme to stimulate economic activity, but it certainly is not without precedent, as both the European Union and Japan are solidly in that camp. Since the Great Recession ended back in the spring of 2009, conventional economics have seemingly been turned upside down and once again here is another example of that disturbing trend. The mechanics of a negative interest rate policy in the simplest form is quite straightforward. Central Banks simply (1) target their overnight deposit rates to a negative interest rate and (2) they issue out additional reserves in order to purchase quantities of outstanding debt driving prices higher and yields lower. However, the behavioral outcomes by consumers, businesses and investors are quite complex and nearly impossible to predict.

In the past, policy makers have had several methods to promote economic growth. Monetary policy was just one instrument in their toolbox. Fiscal stimulus, in the form of government led infrastructure projects or social welfare programs, were common ways to jump start economic growth. Fiscal spending traditionally resulted in improved economic activity, but also inevitably led to greater government deficits. With debt levels now at historic levels as a percentage of total GDP, for all practical purposes that lever is no longer a viable alternative. Tax reform has also been a frequent source of stimulus, but here again, supply-side economics has historically been too optimistic on the amount of additional tax revenue received versus the revenue concessions due to the lower effective tax rates. Reduced regulation has also been an effective resource in stimulating economic activity, but the nature of modern governmental bureaucracy is such that progress has seldom been made on that front. Accommodative monetary policy has become the silver bullet of choice for global policy makers to address anemic economic conditions.

Nominal vs Real U.S. Interest Rates

Interest rates can be viewed in two different ways; the *nominal* interest rate, simply the stated rate; and the *real* interest rate, the nominal rate adjusted for core inflation. Even though U.S. nominal interest rates are considerably higher today than the likes of Germany and Japan, they are still very low relative to where they stood say 15 years ago. As the chart below would indicate, nominal 10-year U.S. Treasury Rates stand today at 1.68%. If that rate is adjusted for core inflation over the past twelve months, the real 10-year UST rate is a negative .71%. So, in effect, even though the Federal Reserve has targeted a Fed Funds rate between 1.75 – 2.00%, the true cost of money is negative due to the influence of inflation.

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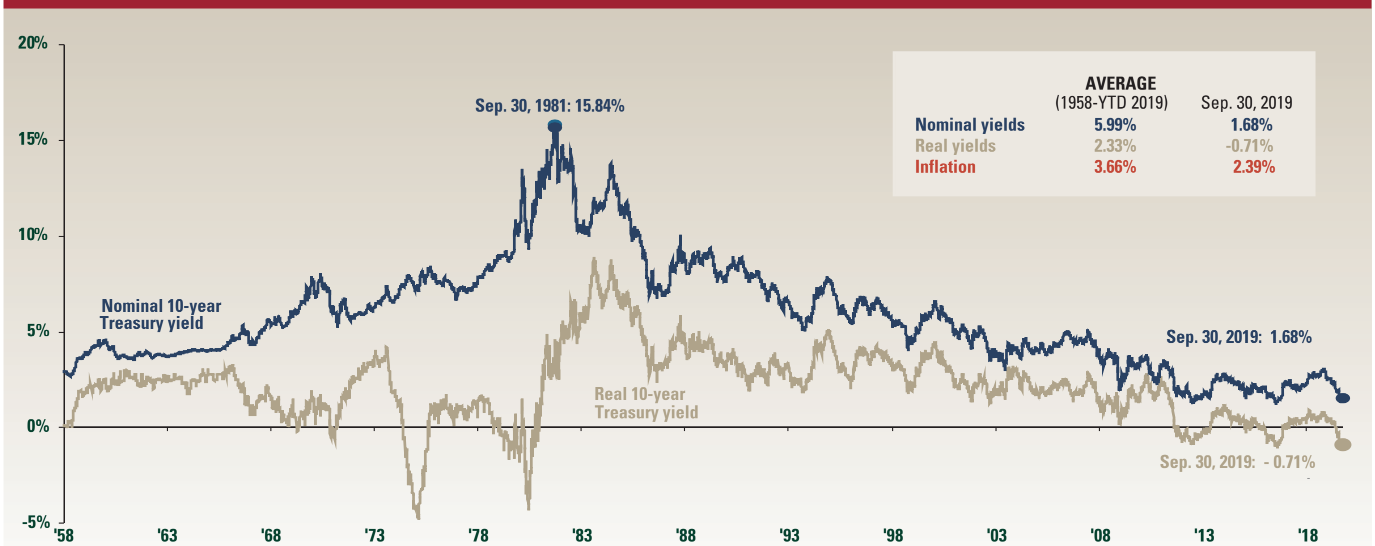
NOMINAL AND REAL 10-YEAR TREASURY YIELDS



Source: JP Morgan Asset Management Guide to the Markets as of September 30, 2019

Brian Christensen, CFA
Senior Vice President & CIO

IMPEACHMENTS AND ELECTIONS AND STOCK MARKETS, OH MY!

Apparently, the stock market gods thought we needed a few more distractions on top of the trade war with China and increased unrest in the Middle East. Enter a formal impeachment inquiry of President Trump and the race to the 2020 elections. While I continue to define much of the daily market reactions to the media and our politicians as noise, I thought it worthwhile to look at prior impeachment proceedings and election cycles for precedents.

In June 1972, the Watergate break-in occurred which began a lengthy investigation spanning until February 1974 when the House of Representatives authorized an impeachment inquiry against then President Richard Nixon. Nixon resigned in August 1974 before he could formally be impeached. From the beginning of Nixon's second term in 1973 until his resignation, the Dow Jones Industrial Average dropped 25% and the S&P 500 Index dropped 32%. Following Nixon's resignation, the indices fell an additional 21% and 15% respectively. The 1973 - 1974 market proved to be one of the worst bear markets in the post-World War II era. But what else was driving investors fears? In October 1973, the Organization of Petroleum Exporting Countries (OPEC) announced an embargo on oil shipments to countries that had helped Israel in the Arab-Israeli War. The U.S. quickly experiences oil shortages and long lines at gas stations while oil prices nearly quadrupled. The Bretton Woods monetary system, which linked the value of all global currencies to the U.S dollar, collapsed in 1973 and currency values reverted to a floating system. Inflation, as measured by the Consumer Price Index, spiked from 3.3% in 1972 to 11.1% in 1974 driven by this series of events ultimately putting the U.S. economy into recession. Clearly, the market had bigger worries than the impeachment proceedings of Nixon.

President Bill Clinton's involvement with Monica Lewinsky made headlines in January 1998 and after a series of hearings and investigations, the House of Representatives voted to begin impeachment proceedings on October 8,1998. The S&P 500 closed down 1.2% after being off nearly 5% earlier that day. In the eleven trading days leading up to October 8, 1998, the S&P 500 lost 10%. By the time Clinton was acquitted in February 1999, the S&P 500 had reversed and increased 28% since the impeachment proceedings driven by the dot-com bubble that was already approaching runaway freight train proportions. Throw in the collapse and Federal Reserve bailout of Long-Term Capital Management and the Russian debt crisis, there were plenty of other distractions for investors not unlike the Nixon era.

So, how do markets react around the presidential election cycle? Yale Hirsch of the Stock Trader's Almanac developed the Presidential Election Cycle Theory founded upon a pattern of market performance corresponding to the four-year presidential election cycle. Hirsch comments that based on his research, "Presidential elections every four years have a profound impact on the economy and stock market. Wars, recessions and bear markets tend to start or occur in the first half of the term and bull markets, in the latter half."

In his 2004 article titled "Presidential Elections and Stock Market Cycles", Professor Marshall Nickles of Pepperdine University identified what he believes is a four-year stock market cycle driven by "the consistency and predictability of administrative actions and campaign rhetoric and their anticipated influences on the economy." Nickles measured market returns from April 1942 to October 2002 and recorded 15 market cycles each averaging approximately 4 years in length. He found that during his measurement period 75% of the market lows occurred close to mid-year congressional elections or in year two of the presidential term.

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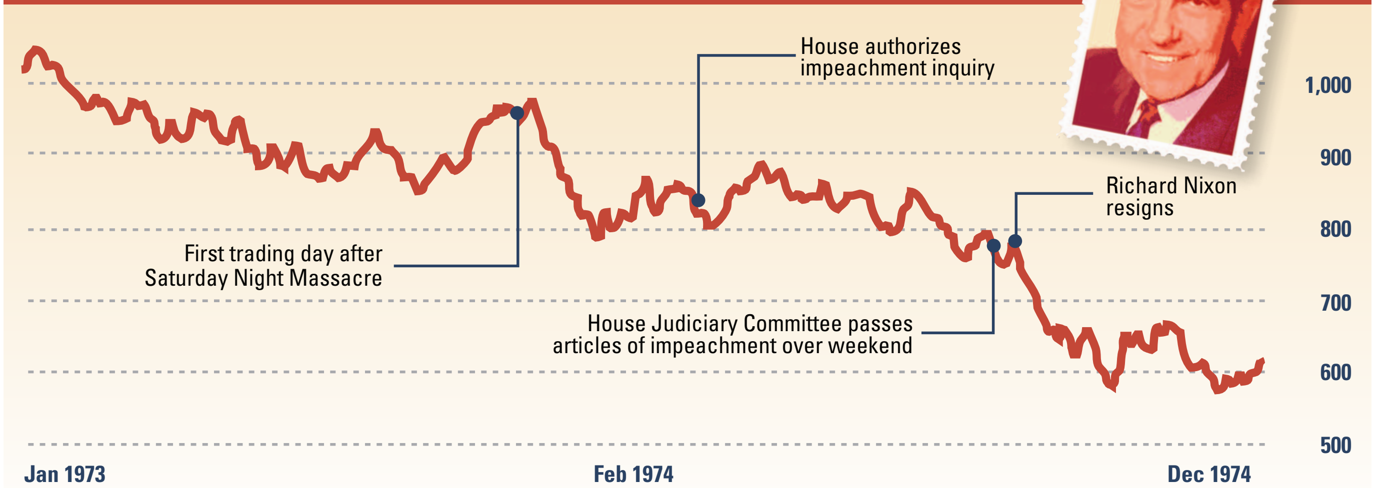
Stock market collapse during Nixon impeachment proceedings
Dow Jones Industrial Average



Sources: Bloomberg, Mamta Badkar/FT

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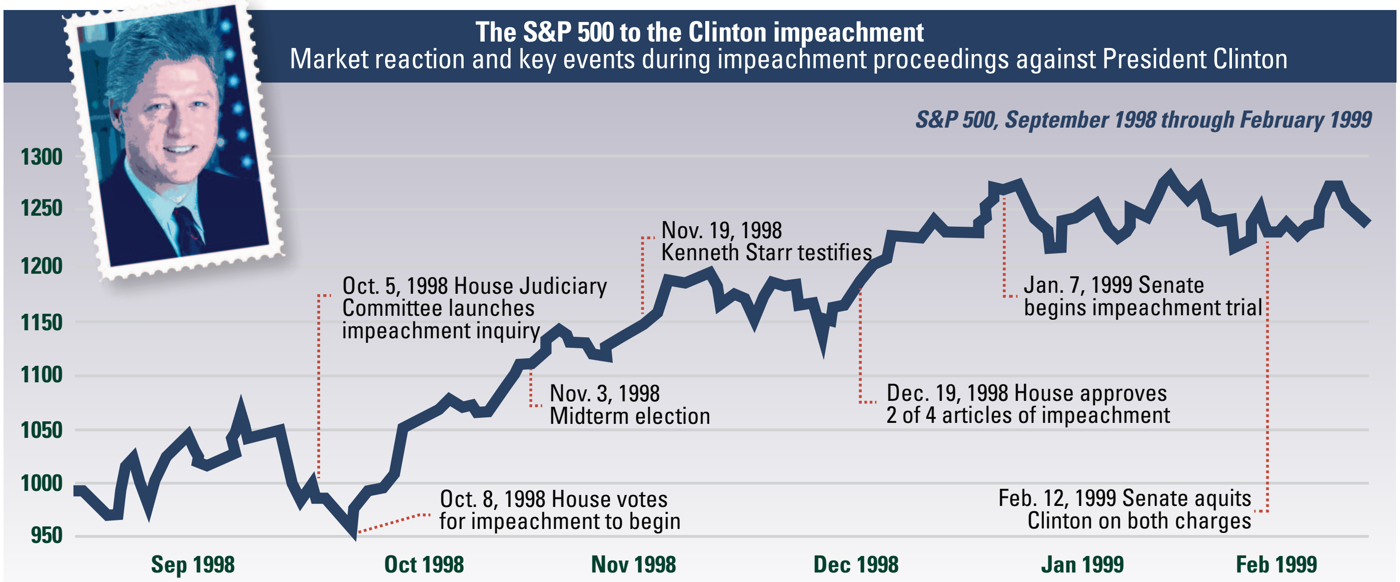
The table below lists the S&P 500 Index results for the period January 1, 1950 through December 31, 2018, aggregated by presidential term years. You'll note there has never been a down market during the third year of a presidential term for the time period measured.

Presidential Term Years - S&P 500 Total Returns
January 1, 1950 - December 31, 2018

	Up Years	Down Years	Average Total Return
Election Year	15	2	9.01%
Election Year + 1	10	7	8.76%
Election Year + 2	12	6	7.94%
Election Year + 3	17	0	19.40%
Totals	**54**	**15**	**11.13%**

If we agree that past is prologue, markets definitely respond to economic data and business fundamentals but are simply distracted by impeachment proceedings. At most, to the extent a president's policies are either pro-business or anti-business, the markets may react directionally in the event a president was removed from office. But from a historical perspective, the significance of such a reaction has been minimal. Clearly, it appears there are market cycles which have varied around each year of a presidential term. The election year and year three are the obvious winners, yet even in mid-years, results have been positive two-thirds of the time on average.

Do impeachment proceedings and presidential elections affect the stock market? Certainly, but the data shows nothing that should make investors panic. Markets go up and markets go down and Wall Street feeds on the volatility. Despite the latest gyrations and growing market uncertainty, we continue to focus on individual company fundamentals. Investing in companies with long track records of navigating all types of business cycles and political environments, trusting seasoned management teams to lead, and ignoring the short-term market noise. Patience and discipline.



Source: Thomson Reuters Datastream – Stephen Culp 4/13/2018

MITCH ZIPPAY, *Accounting Manager*

David Vaughan Investments is pleased to welcome Mitch Zippay, CPA. Mitch received his Bachelor of Science from Southern Illinois University in Edwardsville and has since gained several years of accounting experience in a variety of industries. His experience spans from payroll and capital budgets to complex accounting analysis and preparing annual financial statement disclosures. At DVI, Mitch will oversee the accounting department. He will manage the day-to-day critical functions of payroll, accounts payable and accounts receivable, as well as creating internal accounting policies and procedures and preparing monthly forecasts and yearly budgets.

Mitch and his wife, Jessie, live in Morton and have one daughter, Lilah. In his spare time, Mitch enjoys playing golf, spending time with family and friends, and traveling. Thus far, his favorite destination has been the Island of Jamaica.

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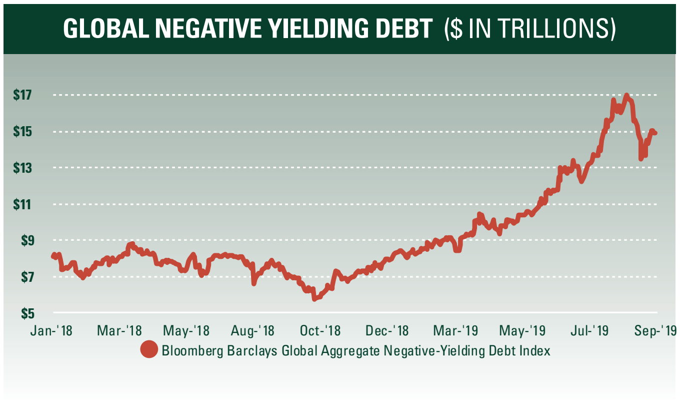
Impact on the Banking System

A strong banking system is a fundamental necessity for any country to maintain a strong and resilient economy. Embracing a negative interest rate strategy, by its nature, places stresses and strains on the economics of banking and, in practice, generates a host of unintended consequences. In theory, the goal is to incent commercial banks to lend out money rather than earn negative rates of return on their reserves. In theory, the attractive lending rates are to spur loan demand and economic consumption. All well and good. But what happens if companies and individuals elect to pull their deposits, avoiding the cost of carry, and direct those assets to be placed in bank notes held in a vault or stuffed into their mattress? The hypothetical run on the bank would result in higher short-term rates as banks would be forced to pay more for scarce deposits. There is also the behavioral finance element to all of this. Why are we in a negative interest rate environment to begin with? Do businesses or consumers really wish to take on risk or make major capital acquisitions when policymakers are advertising current conditions as extraordinary economic times?

The New Normal?

Negative interest rates and quantitative easing were designed to be extraordinary measures to address extraordinary economic disturbances. Each were meant to be a possible solution; an experiment, to be viewed in isolation and over a brief period of time. As it turns out, that is simply not the case. The European Central Bank adopted this policy back in 2014 and the Japanese Central Bank followed suit in 2016. Now as the chart to the top right depicts, nearly $15 trillion dollars of global debt maintains a negative interest rate. And to date, the jury is still out on the overall long-term economic success of this tactic. Because of the magnitude of the policy as it stands today, the path forward to unwind all of this is a bit unclear. Asset values on real estate, fixed income securities and common stocks have all been positively impacted by this approach and abruptly turning off the spigot of accommodative monetary policy could have disastrous results.



Source: Bloomberg

The Current State

One cannot argue that lower relative interest rates around the world have resulted in a flow of funds into the U.S. from both private and public savings and reserves. This has resulted in both a move lower in U.S interest rates and general price support for U.S. common stocks, and in recent months especially for those maintaining attractive dividend yields. Investors must be cautious however as low or negative interest rates alone, in isolation, cannot single-handedly put a floor and stabilize the global economy. In our current environment, resolving trade skirmishes and reducing regulatory impediments would, in combination, be a far more powerful catalyst to drive future economic growth. Using a lower hurdle rate encourages the right kind of economic behavior, but an environment of greater certainty and efficiency affords decision-makers the ability to take on greater financial risk.

HANK LEBIODA GOLF CHALLENGE

SUNDAY, DECEMBER 8, 2019, from 2:00 to 5:00 PM at Drive Shack in Orlando, FL

DVI is excited to sponsor the inaugural Hank Lebioda Golf Challenge. Participants assemble a six-person team to play alongside Central Florida native and PGA Tour Player, Hank Lebioda, in Drive Shack's augmented reality driving range. Silent auction items will be available to bid on during the event, and the winning team will have the opportunity to take home some great prizes! The event will be topped off with a full buffet service and an excellent beer & wine selection. All proceeds from the event will go to the Crohn's and Colitis Foundation: leading the way for over 3,000,000 patients through research, education, and support. For more information on the event and to sign up your six-person team visit www.GolfChallenge.givesmart.com.