Dangerous Words

"Once a new technology rolls over you, if you're not part of the steamroller, you're part of the road."   – Stewart Brand

The late, irreverent comedian George Carlin delivered to the public the seven words you can't say on TV. I suspect many of today's investors ignore the censor and utter these seven words with some frequency, if only under their breath. However, there remain five words investors should still use with caution: "It is different this time." It is always questionable to think that the past is passé and the future promises a new world with new rules.

Is "different" happening now? Economic growth by almost any measure remains stuck in second gear. Interest rates have been unusually low for several years, and it seems we are becoming a little numb to this situation. There is even a term for today's rates—the "new normal." Yet, looking solely at today's low rates, there seems to be an element of irrationality that I cannot reconcile. So, rather than write (again) on why rates should rise, it is worthwhile to ask this "what if" question: *if* low rates are here to stay, *what* would explain this?

INTEREST RATES 101

In its most basic form, interest is compensation for the time value of money. One dollar in your pocket today is worth more than one dollar a year from now. If I borrow $100 from my good ole' brother-in-law Jim, he certainly will want back more than he lent me. By my calculations, Jim would be smart to charge me at least 4 percent: 2 percent for the time value or real rate plus 2 percent to compensate for inflation. If Jim questions my ability (or willingness!) to repay, he would be wise to add additional interest on top of the 4 percent. This is how the bond market works, or how it *should* work.

Yet, the bond market has not been working like this. Focusing on U.S. Treasuries maturing in two to five years since at least 2011, these bonds have *consistently* yielded less than inflation and barely compensated the investor for the time value of money. We are now five years removed from the Great Recession and real rates are lower now than they were in June 2009. Why have we investors accepted this situation? Have we lost our collective heads?

THE USUAL SUSPECTS

Before concluding that this is just one mixed-up market and mumbling a few of Carlin's seven words, let's examine possible reasons for these negative real rates. Let's first review the arguments I hear most often (and have offered myself), which I find a little unconvincing:

- ***Real rates are negative due to weak economic growth and high unemployment.***

  There may be a connec- tion, but I am skeptical of a cause-and-effect relationship. During similar periods of low/negative growth or high unemployment, interest rates were higher than they are today. Historically, U.S. Treasuries offered investors the 2 percent "brother-in-law" real rate, not today's negative 1 percent rate.

- ***We had excessive debt buildup before the meltdown and have been experiencing de-leveraging since the meltdown.***

  I am sympathetic to this argument except for one problem: in total, we have not experienced a reduction in debt. While debt has not grown as fast as the economy since the meltdown, it has still increased and remains quite high. Maybe we have simply piled on too much debt and this debt is sucking the life out of the economy. There is empirical support for this connection. If this is true, at some point investors should worry about the ability of borrowers to repay and charge a higher interest rate, not a lower one.

- ***The Fed is keeping interest rates low.***

  This is the simplest and therefore most appealing argument. However, the Fed is on course to end its purchases of government and mortgage bonds by year-end and has signaled it might start to raise short-term rates in 2015. Theoretically, the bond market should already be out in front of the Fed and pushing interest rates up. Other types of bonds, such as corporate bonds, are yielding negative real rates as well, even though the Fed has not been buying them. While corporate rates are based upon a spread over Treasuries (the added interest for the possibility I will not repay good ole' Jim), the Fed doesn't control this spread.

Since these reasons don't deliver a full explanation, what else could provide insight into the "what if" question? There are a variety of suspects, but let's focus on two possibilities, which happen to be related.

DEMOGRAPHICS

Like much of the developed world, our population is getting older *and* we are having fewer children. This situation is a double whammy for the economy. Economic growth is the combination of population growth and productivity. So, to keep the same economic engine humming, slower population growth has to be offset by increased productivity. This is hard to do with an aging population. While older workers may be more productive than younger workers, they don't *improve* their productivity at the same rate. Old dogs can learn new tricks, it just usually takes them longer.

Factor in the sharp decline in the working population over the past decade, and the demographic headwind becomes stronger. The percent of the population in the labor force has dropped to lows last seen in the late 1970's, before most women entered the workforce. Many people have been forced out or removed themselves from the workforce. There is a big difference between being temporarily unemployed and simply not seeking work. Skills erode. Motivations and attitudes change.

What does all of this have to do with our pitiful bond rates? Some research shows the demographic headwind is highly correlated with lower returns for both stocks and bonds. As for the negative real rates on many bonds, this research suggests that shorter-term bonds may be more properly viewed as simply providing *insurance* for the downside of riskier investments. Therefore, ex- pecting a positive real return is unrealistic. If stock returns are expected to be mid-single digit under this theory, there is not much room between this stock return and zero to squeeze in safer assets such as bonds.

TECHNOLOGY

There is a growing debate about technology's impact on the economy.

We can all agree that our slower population growth must be offset by stronger productivity. And with an older and slower-growing workforce, increased pro- ductivity depends more and more upon continued innovation.

Here's where the views diverge: some argue that true innovation is stagnant, as evidenced by the marked slowdown in inventions in recent decades. In addition, the Great Recession caused a sharp drop in investment spending and financial risk taking from which we have not completely recovered.

But, like the Great Depression in the 1930's, this recession did not end innovation. And, even though many of today's innovations are the commercialization of past discoveries, these innovations are far-reaching and life enhancing. For example, society already benefits from the near-instantaneous connecting of people all over the globe. Everything from healthcare and education to commerce and even friendship thrive in a world of improved communication.

Whether current innovations are original or are the commercialization of former discoveries, they share one common element at their core: digital information. The significance of this cannot be overemphasized. Digital information makes today's climate especially challenging and very different from the patterns of the past because it defies the traditional economic principles of scarce resources. Unlike other assets, digital information can be more valuable as more people utilize it. This information can also be used by many people at the same time with minimal added cost to the provider. The volume of data as well as the speed and capacity needed to spread the data have all experienced exponential growth as processing costs have fallen precipitously.

Some argue that most of today's innovations are small, or *micro-innovations.* But given these exponential changes, small innovations can add up quickly. Just a few people can create something big - fast. Facebook and Google, two of the largest companies in the market, are built on digital information. Google started 16 years ago; Facebook 10 years ago. Facebook estimates it has over one billion users, 70 percent outside of the United Staes. Over the last five years, Google has successfully road tested driverless cars for over 700,000 miles. Imagine where this technology might be in another five years and who could benefit from its development.

The concept of creative destruction seems to be at work, with digital discoveries leading to weak employment and perhaps low growth and low interest rates (*for the moment*). Previous inventions eliminated jobs from some industries, but ultimately created new opportunities, new jobs, and a more vibrant economy. Today's digital discoveries may indeed affect the economy differently than earlier discoveries by making the destructive side of creative destruction more painful. Google and Facebook employ a fraction of the employees needed by companies in most other industries to generate equivalent revenues.

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