The Perspectives Podcast
The Price of Money
Episode Three

with
Candace Browning
Head of BofA Merrill Lynch Global Research

Michael Hartnett
Chief Investment Strategist,
BofA Merrill Lynch Global Research

and
Chris Hyzy
Chief Investment Officer,
Merrill Lynch and U.S. Trust

Katharine: My fiancé was going to back to teach, we were getting married in a month. There were a lot of reasons to not buy. We ultimately decided that we had to pull the trigger. It might be our last shot...

Candace: That's Katharine Crnko a freelance writer from Los Angeles. She and her now-husband, Matt Gilpin, an assistant professor at USC, spent years waiting for the right opportunity to buy their first home. Ultimately, it was the recent rise in mortgage rates that got them to move.

Matt: Honestly we kinda stood there and said "oh my god, what have I done?" 'Cause the two of us have spent, you know, most of our lives trying to not be in debt and now all of the sudden we have all the debt in the world...

Candace: The American economy is currently experiencing one of the longest economic expansions in history. Now a big reason has been the ultra-low interest rates of the past several years, making cheap money available for everything from mortgages and car loans to business investments. And all that spending and investment has been great for growth. But it can't go on forever.

Candace: You're listening to the Perspectives podcast. I'm Candace Browning, head of BofA Merrill Lynch Global Research, and with me is Michael Hartnett, chief investment strategist for BofA Merrill Lynch Global Research.

Michael: Hi Candace.

Candace: And Chris Hyzy, chief investment officer for Merrill Lynch and U.S. Trust.

Chris: Hey Candace.

Candace: On today's episode we're going to look at the price of money and what higher interest rates could mean for you and for your financial life. But first, a bit of historical context. SFX: CBS News this is News Break...wholesale prices were up again in February at nearly a 20 percent annual rate. After that inflation report, most major banks raised their prime lending rate to 17 3/4 percent for corporate.....

Candace: You heard that right. That was back in 1980 when the prime lending rate reached as high as 21.5 percent. But in the decades that followed, they charted a steady downward path. Rates hit historic lows following the 2008 financial crisis, and stayed there for the most part for several years. But now they're back on the rise. A key turn came at the end of 2015 when the Fed hiked the Fed funds rate for the first time since 2006, and other interest rates like the 10-year Treasury bond, a benchmark for things like mortgages and corporate borrowing, began to follow suit.

Candace: So let's delve into this. Chris, many of us could argue that rising interest rates were a long time coming. But what was actually behind it?

Chris: You have four main aspects that are driving interest rates. The first one is the traditional inputs like we mentioned, inflation, capital flows, and perhaps a level of growth. The second area is the fact that the debt shelf, the overhang of debt shifted from the household to the government sector, particularly on central bank balance sheets. The third aspect of it is just general central bank policy. And then last but not least, the structural dynamics the demographics around the world in terms of aging and a number of other things. You put all of those things together you have what is a yield curve that has many more stimuli on it than ever before.

Michael: Yeah, I would agree. I think that interest rates are still very low. The Fed Funds is around about 2% which is the policy rate in the US and if you look at policy rates in Europe and Japan, they're still effectively at zero. So interest rates are incredibly low. They're not as low as they were two years ago but two years ago they were the lowest in 5,000 years, so you know they could hardly go a lot lower. But what's allowed certainly the U.S. interest rates to rise is the two things that the Fed follows. One is inflation and the other is unemployment. They're just not as you know troublesome as they once were.

Michael: You know, unemployment as we know is the lowest level in the U.S. you know since the late 1960s so at some point the Fed's going to say, "Well, that low level of unemployment is going to lead to wage growth. We can't allow wage growth to pick up too much. We've got to start you know, tightening policy a little bit more." And the other thing that's happened is that inflation you know again, which as Chris says, has this enormous structural sort of impediments to pick out, whether it's the aging of the population or the amount of debt that's out there or of course the disruption of technology, cyclically that's just been able to sort of lift enough for the Fed to say, "Let's go."

Candace: So when the Fed starts to raise rates, if you look back in history, how often do they overshoot?

Michael: Well, they overshoot every time because that's the nature of the beast. You know it's incredibly difficult to know what is the perfect level of interest rates because interest rates affect so many different things at any one time. So, it's always an experiment. I think what's interesting about today's experiment is that the Fed is erring on the side of caution in terms of the speed with which it's raising interest rates and the magnitude by which it wants to raise interest rates. Because it knows that the scars of the great financial crisis are still very, very deep. So, it's trying to give the economy as much time as it can to fully recover. And the Fed has actually gone out and actually said, “You know what? If you want to overheat a little bit, you know, we'll take it. You know, that's okay,” which is quite unusual for a central bank to do. So eventually they'll raise rates and you know, someone will feel the pinch.

Chris: And Michael used the word experiment. That is the perfect word for

Michael: Thank you Chris-

Chris: … not only what went on, but what is going on now and what's likely to go on for a while. So, you know the Federal Reserve should put their lab coat on right now as well as the ECB and the Bank of Japan because this is a giant experiment. And there has never been 13 trillion plus on the three largest central banks in the world on their balance sheet, and how do you unwind that and allow the interest rate dynamics to not go haywire. That's number one.

Number two, when you think just about the natural rate of inflation, the Fed's target somewhere around 2.5 give or take a few basis points. How do they manage to get to that level? And we all know there's a lag in policy before it actually sticks. And I would argue this experiment that's going on now is probably the largest experiment so the lab coat is going to be on for quite a while.

Candace: You both talked about feeling the pinch and unwinding the experiment. But this does have an impact on people’s lives; one of the most obvious relates to mortgages. So let’s turn back to Katharine and Matt, and hear more about their experience.

Katharine: We've been looking at interest rates for the past couple of years and to be totally fair we've been looking at interest rates since 2008 because suddenly everyone needed to know what a healthy mortgage was and what a not healthy mortgage was.

Matt: Psychologically right now a house feels like the best investment on earth. I started working at the bottom of the financial crisis and so all I have seen is house prices go up and you know I've seen friends that were able to get in much earlier than me basically make double returns on their homes. In reality if you consider, you know, historical home price increases of, you know, a couple percent a year, there's definitely ways to get a larger return on money. However, you know, having a bunch of index funds doesn't feel like a home.

Candace: So, what's your take on this Chris and Michael? As we heard from Katharine and Matt, interest rates were a big factor in their decision to buy when they did. Will interest rates continue to be a concern?

Chris: It's always a concern, particularly as interest rates are rising. It's one of the most Important decisions one can make, as a couple, as a family, as you are starting to build wealth and creating your life plan, in general. There's a few things you can do to alleviate the concern of rising costs as rates go up.

The first thing you could do is you could put more money down. That will lower the cost on a monthly basis and lower the overall size of the mortgage. The second thing you can do is you can actually go to an interest rate that's lower by decreasing the length of the mortgage. Some people take out 30 year mortgages, others may go to a 10 year mortgage and that brings the interest rate down. But then, there's a third aspect to that. If you have a lower life of a mortgage sometimes you get an adjustable rate mortgage. After the length of that mortgage ends, it begins to float up or down with the level of interest rates. That could bring costs down in the future, if interest rates come down.

But the big risk is that interest rates actually go up, like you're seeing right now. Which means if rates are going up because interest rates are going up, and they're floating higher on a per month basis, you might spend less on something else.

I would say this, though, if interest rates marginally go higher, on a grind it out basis, that is okay as long as the overall economy is doing well. If they sharply increase, that’s when you can get a pretty sizeable dent in the housing market.

Candace: Michael?

Michael: I think the rate rise that we've seen today in the U.S., there is some evidence that the margin it’s beginning to work into slightly lower housing activity, so it’s something that certainly needs to be watched.

I think also the big thing to remember about the last 10 years is, you know Chris sort of mentioned it a little earlier on, 10 years ago the consumers had all the debt. Now it's the corporations and the government that has the debt. The household balance sheet is looking in far better shape. The next recession is not going to be about the consumer, it's not going to be about the housing market. That was 10 years ago, 15 years ago. Next one is really just going to be about sort of government debt and corporate debt and what interest rate affects those areas of the economy because at the end of the day the household balance sheet is in you know historically very good shape right now.

Candace: But if I'm a consumer, I'm kind of facing some headwinds because everything that I'm buying from China now is going to get more expensive, my gasoline prices are going up, and I'm going to have to pay more on my credit card debt. So could one of the impacts of rising rates actually be a slowdown in consumer spending?

Michael: Well it normally is. Of course part of the reason the Fed is raising interest rates, part of the reason the price of money is rising is because there's lots of spending. Certainly from a short term basis at least on the part of both the government and the corporate sector there’s not enough saving. So I think that there's no doubt that at some point rising interest rates will put a break on consumer spending because the rising interest rates are also a reflection like you say Candace of rising prices. But it's when those rising rates, those rising prices coincide with rising unemployment, that's when you’ve really got to start to worry. We're not at that point quite yet.

Candace: So how should I prepare for these rising rates?

Michael: Well, I think you're already seeing it in portfolios quite frankly in that what you've seen or one of the biggest areas of growth this year at least I've seen is T-bills you know, because unlike the German or the Japanese person who is stuck with zero interest rates, at least in America you can now, I don't know what a six month T-bill is, but it may be 2.5%, maybe a one year T-bill's getting up towards 3%, that's not bad, and incidentally is one of the reasons the dollar's going up this year is because people actually see there is an income I can get owning cash or owning, you know, fixed income in the U.S. So I think that there are opportunities that arise from rising interest rates, and one of them is a shift toward sort of lower duration assets, and you know they've actually got a decent yield at this particular moment.

Chris: And one of the largest dynamics in the marketplace in the last decade as interest rates went to record lows, Michael hit on it, which is the search for yield. And it originally started at the longer duration assets, either the 30-year Treasury bond or the 10-year, even in-

Michael: People were buying 100-year Argentina bonds two years ago.

Chris: 100-year Argentina bonds

Candace: So what you're really saying is that for fixed income investors it's the first time in a decade that they can keep up with inflation on short-dated risk free assets, and that's an opportunity.

Chris: Great opportunity.

Candace: So we've talked a lot about bonds and what that means for investing. But what about the outlook for stocks? I mean, could higher rates potentially derail the strong equity market and the strong corporate earnings environment that we've been in for the last several quarters?

Michael: Eventually yes. I mean I think that era of excess returns has ended because the era of excess liquidity that forced interest rates down to zero, that's over as well. So, what happens now is the onus is really on earnings. You know, if you want this market to go up, it's going to be earnings that are driving it. You haven't got that tail wind now of interest rates on your side. Unless of course, you know, they stop going up. Because we find out we're just in one of those periods of history where there isn't inflation, you know because of the technology, the demographics, the debt. In which case you end up with a much higher multiple on the equity market. But again, it's very dependent on inflation and interest rates not going up.

Chris: It comes down to Candace exactly what you said which is, what is that level of interest rates where the spending and the overall economy, not just here in the United States but globally, begins to not only pull back but bite into the level of growth that is a natural run rate for an economy. We still feel comfortable about the level of earnings but the growth of earnings is starting to come down.

Candace: So we've talked about you know our fixed income allocation and where we see opportunities in short dated fixed income, and we've talked about the fact that the stock market, as you said Michael, earnings growth is probably going to slow a little bit. But we also want to invest through the cycle. So what kinds of sectors or types of company should I be looking at?

Michael: Well, quite frankly it is the banking system that is most sensitive to interest rates. So for example, if the Federal Reserve right now has an interest rate of 2%, the Federal Reserve I think is saying that it wants that interest rate to go to 3% over the next 12 to 15 months. If it's able to do that without major disruptions to markets, the financial sector is going to do well.

Another sector that has not done as well in the past 10 years, the resources sector, energy, materials, again, if interest rates are going up because there's a little bit more pricing pressure in the economy, that again is traditionally something that tends to do well at this stage of the cycle.

But the closer you get to the end of the cycle, what will work very well as a theme is companies that just have a lot of cash, companies that have excellent balance sheets, they could be some tech companies, they could be some consumer staples companies, you know, there's a variety of them. Health care is obviously another great example.

Candace: Chris?

Chris: When you get into this late cycle, those areas that did not participate in the last 10 years largely speaking, many of which did not benefit from a decline in interest rates, should begin to take over as leadership — the industrial space, aerospace and defense, the earthmovers, the infrastructure areas, those are the areas that have so called been "left behind."

However one of the big caveats out there is the fact that we're still early in this innovation cycle. So there's a good chance that some growth sectors still perform alongside the sectors that have been left behind.

The right way to build a portfolio in this part of the cycle is to own both, to continue to expose to the disruptors, to the innovators—areas such as cyber security, the cloud, sensory chips—that are going to drive growth through the cycle, but also start to add into the areas that have been left behind, areas that have traditionally been known as cyclical value

Candace: Great. Well, thank you very much.

Candace: You've been listening to the Perspectives Podcast. My co-hosts are Michael Hartnett, and Chris Hyzy. I'm Candace Browning. For further insights, listen to other episodes in the Perspectives podcast series. Thanks for listening.

This podcast was published on November 15, 2018.

economic, market or political conditions and should not be construed as research or investment advice. The investments discussed have varying degrees of risk.

Banking, mortgage and home equity products offered by Bank of America, N.A., and affiliated banks, Members FDIC and wholly owned subsidiaries of Bank of America Corporation. Equal Housing Lender. Credit and collateral are subject to approval. Terms and conditions apply. This is not a commitment to lend. Programs, rates, terms and conditions are subject to change without notice.

Investing in fixed income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Investments focused in a certain industry may pose additional risks due to lack of diversification, industry volatility, economic turmoil, susceptibility to economic, political or regulatory risks, and other sector concentration risks. All sector and asset allocation recommendations must be considered by each individual investor to determine if the sector is suitable for their own portfolio based upon their own goals, time horizon, and risk tolerances.

Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad.

U.S. Trust operates through Bank of America, N.A., and other subsidiaries of Bank of America Corporation. Bank of America, N.A., member FDIC.

Merrill Lynch makes available products and services offered by Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S") and other subsidiaries of Bank of America Corporation ("BofA Corp."). MLPF&S is a registered broker-dealer, registered investment adviser and Member SIPC.

Investment products:

Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value

This podcast should not be copied, distributed, published or reproduced, in whole or in part. Neither U.S. Trust, Merrill Lynch nor any of their affiliates make any representation or warranty, as to the accuracy or completeness of the statements or any information contained in this podcast and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed.

 ARQNFRGK