Marble Harbor Investment Counsel, LLC
Excerpt from
Third Quarter, 2019 Letter

We are pleased to send an excerpt from our third quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb and Daniel Rosenblatt

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Dear Client:

"Neither a borrower nor a lender be."

Contrary to Polonius' advice, we're all borrowers and lenders. You're a borrower when you take out a mortgage to buy a house. Perhaps less obviously, you're also a borrower through the companies you own when they issue debt to build a factory. Municipalities and countries are borrowers when they issue debt to build a bridge or an aircraft carrier. You're a lender when you buy a bond from a company or the U.S. Treasury. You're a lender when you put money in your savings account at the bank.

In the past, the price of money has, as a rule, been positive. When we lend money, we get paid for that service. When we borrow, we pay for that privilege. But today something unusual has happened: There is $16 trillion of government debt with *negative* interest rates. That's right, lenders are paying borrowers for the right to hold their money! Viewing money as just another commodity, like steel or wheat, allows us to see that it obeys the same laws of supply and demand as do other goods. At the moment, globally there is a glut of supply (surplus cash) and relatively little demand to borrow.

Negative interest rates first appeared in 2014 in the European Union when, in an attempt to kickstart the faltering economy, the European Central Bank cut its deposit rate to -0.1%. Firms were being *paid* to borrow money. The theory was that this would encourage them to borrow more and invest.

But why would European banks lend money at negative rates? The reason becomes clearer when viewed within the context of post-financial crisis regulation. As a stabilizing measure, banks were forced to hold a certain percentage of their capital in European sovereign debt, which was self-servingly defined by regulators as a "safe asset." Thus, European banks were, and continue to be, compelled by the government to buy this debt no matter how low rates go – even to less than zero. Unfortunately, in a shining example of the law of unintended consequences, instead of stabilizing the financial system, the negative interest rates initially manufactured by regulatory fiat have led to widespread concerns about a potential economic slowdown in Europe. Ironically, this creates an economic basis for sub-zero rates – if you think further deflation is on the horizon, it's perfectly rational to buy a negative-yielding bond. So, what began as an attempt by the E.U. to return the

economy to growth has become a morass. As an aside, while the origin story is different, Japan, who has endured 20 years of little growth, is experiencing a similar phenomenon.

Negative interest rates in Europe and Japan make the U.S. ten-year Treasury Bond at 1.5% seem downright generous. Understandably, European and Japanese firms are investing in Treasuries, but this has the consequence of pushing U.S. yields down. The E. U. and Japan are exporting low interest rates. A 1.5% return equates to a 66 price-to-earnings ratio (P/E), a common valuation metric. Compare that to stocks that today yield over 2% with a P/E of 17. Historically, that's slightly on the expensive side, but nowhere near the 66 P/E of bonds.

This is a terrible time to be a lender – 1.5% for ten years is a lousy return and leaves no room for the inevitable ups and downs that happen to companies, governments and economies. Conversely, now is a wonderful time to be a borrower. If you can refinance your mortgage, rates are near the lowest they've ever been. And if you happen to live in Denmark, you're truly in luck: You can refinance your house at negative rates. That's right, Jyske Bank will pay *you* to take out a loan.

Many companies are taking advantage of the low rates to refinance and extend their debts. AAA-rated Berkshire Hathaway was able to borrow at 0.44 % in Japan. Even lesser rated companies, like BBB- homebuilder Toll Brothers, were able to borrow at under 4%. This results in lower interest payments and allows for more reinvestment in the business, higher dividends and more stock buy backs. While there has been much talk in the financial press about the amount of debt on US corporate balance sheets, we believe that within reasonable parameters, it's rational – and even prudent – for firms to borrow when money is so inexpensive.

So, where are we looking for yield to support your income? Stocks are generating 2% and the dividends of quality companies will likely grow over time. High quality corporate bonds yield 2%, and some utility preferreds and REITS produce about 4%. Floating rate loan funds are at about 6%. You may see a combination of these instruments in your portfolio. You may also see shorter-term Treasuries that yield *more* than 5- or 10-year Treasuries and also act as a weather anchor and a liquid place to hold cash.

This is an historically upside-down period in the bond market. Ten years ago, we could have relied on bonds for a healthy return to support your income. With today's bonds yielding less than the inflation rate, the best you can hope for is the return of your capital, not a return on your capital. For this, we need to look to stocks. We are comfortable with the businesses embedded in our companies and confident that over time they will grow their earnings and cash flows, leading to that return on your capital.

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