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Getting Our Heads Around Negative Yield

You may have heard the news that world bond markets now offer something like $16 trillion of sovereign debt with *negative yield*. How did that come about? Has it worked? Can you actually get paid to borrow money? And who's buying all that negative-yielding paper? Answers to those questions might be summarized as follows.

A confluence of factors: This trek into new financial frontiers started more than five years ago as the European Central Bank (ECB) sought to address stubbornly slow economic growth. The ECB figured that charging the banks, via negative rates, to hold their excess reserves would induce more lending.

Meanwhile, Japan has been grinding its way to negative rates in a decades-long effort to recapture the vitality that characterized its economy more than a generation ago. And China's central bank recently announced new stimulus measures, including rate cuts, to combat its own growth slowdown.

By comparison, U.S. economic performance has looked pretty solid. However, high-quality bonds, especially U.S. Treasury issues, have seen huge demand, driving market yields to historic lows. The perceived safety of those credits denominated in the world's reserve currency at still-positive, albeit meager, yields has been a powerful magnet for conservative money from all quarters.

So far, not that well: For the most part, European bank lending has not expanded as the ECB may have hoped. Returns for savers and financial institutions appear to have suffered without a commensurate boost in the region's economy. Germany's industrial production in the second quarter saw its largest pullback since 2009. Italy's economy has not grown this past year, and France barely managed a 1% gain. Those countries that *are* doing well, such as Poland and Hungary, are not large enough to pull along the rest of the Eurozone.

Maybe, if you're the right borrower: Opinions vary as to whether yields on the highest quality U.S. debt might slip below the *zero bound* (in Fed-speak). Even then, you may not want to hold your breath waiting for your mailbox to fill with offers of a negative-rate mortgage. Lenders are unlikely to view most of us as *sovereign* credits.

You might be surprised: Nevertheless, U.S. investors *are* touched by the negative yield phenomenon. That cycle of easy monetary policy, followed by low inflation, followed by even easier monetary policy, has sucked cash into bond funds – especially the indexed variety. Those fund managers must buy securities in keeping with the weightings of the index they track. For global bond portfolios that can include a requisite measure of those negative-yielding issues.

Active mutual fund managers, hedge funds, and other sophisticated investors can try to seize short-term trading opportunities along the yield curve, play currency bets in an effort to offset negative yield, or seek to borrow at those super low rates to buy higher yielding securities (referred to as a "carry trade").

In other words, the great flight to safety may not be as simple to define nor as easy to unwind as it would seem. There might be just a little more upside than suggested by the prospect of "negative yield," but also more risk than implied by the term "sovereign debt." ■

A Brand New Theory Serving the Same Old Desires

Starting about 26 years ago, bond investors suffered a yearlong drubbing that saw the yield on the 10-year Treasury rise from 5.2% to just over 8.0%. Informally called the "Great Bond Massacre," that sell-off was widely attributed to concerns over federal deficits. Faced with such a disciplining force, James Carville, political advisor to President Clinton, quipped that he would hope to be reincarnated "as the bond market, because you can intimidate everybody."

How things change! Deficits for fiscal 1993 and '94 amounted to 4.4% and 3.6% of gross domestic product (GDP). This month the government will close fiscal 2019 at a deficit of about 4.5% of GDP, up from 2018's 3.9%. Yet, the bond market is not just unperturbed; it has rallied to historic low yields.

Then there's the recent example of 2009-2012 when deficits ranged from 7% to nearly 10% of GDP. Those record post-World-War-II deficits were countering a global financial crisis and steep recession. The Federal Reserve and other central banks pressed short rates down and launched multi-year bond-buying programs ("quantitative easing").

Today, a fresh set of economic and geopolitical concerns are feeding into central bank accommodation and prompting a flood of capital into sovereign debt, especially U.S. Treasury securities. (See the accompanying article on the phenomenon of negative yields.)

Notwithstanding these marvels of recent market history, can credit really be so aggressively expanded

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Will Greece Be the "Comeback Kid"?

Eighteenth century political economist and philosopher Adam Smith famously noted that, "There is a great deal of ruin in a nation." He seemed to be suggesting that countries can survive and even prosper over time despite the malfeasance and missteps of their leaders. A decade ago, Greece appeared to be testing the limits of that premise.

As the poster child for economic inefficiency, suffocating bureaucracy, and chronic tax noncompliance, Greece was laid low by the 2008-09 global financial crisis. Heavy debt and soaring deficits prompted it to seek emergency help from the European Union and the International Monetary Fund.

Although it represented just 3% of the Eurozone economy, Greece posed the EU's first real crisis of management since the launch of the euro in the late 1990s. Despite a series of bailouts totaling $330 billion, Greece found itself locked out of the international bond market in 2010.

This year, investors appear to be making an Adam-Smith-like leap of faith, as Greek stocks have handily outperformed their peers in Europe and among emerging markets. Its sovereign debt has seen a couple of upgrades, although it is still below investment grade. One catalyst for those constructive sentiments is Greece's new prime minister, Kyriakos Mitsotakis, who has promised tax cuts and bureaucratic streamlining for projects designed to boost economic growth.

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Investment Performance Review	TOTAL RETURN * (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized through Sept. 6, 2019 ---**			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Blend)	4.0 %	11.4 %	8.5 %	12.2 %
Mid-Cap Stocks (Blend)	- 2.3	7.9	5.5	11.5
Small-Cap Stocks (Blend) †	-10.4	6.4	5.3	11.1
Foreign Stocks (Large Blend) †	0.1	4.9	1.9	4.9
Diversified Emerging Markets †	2.7	4.7	0.2	4.1
Specialty Natural Resources †	- 11.3	1.4	- 3.5	3.4
Specialty Real Estate †	13.7	5.8	7.7	13.2
Cons. Allocation (30-50% Equity)	5.1	5.0	3.7	6.5
Long-Term Bond	18.9	5.6	6.4	7.7
World Bond †	6.0	1.6	0.8	2.6
High Yield Taxable Bond †	5.7	5.2	3.7	7.2
Long-Term Municipal Bond	8.9	3.1	4.0	4.6

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks, high-yield (lower rated) bonds, and sector-specific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.

Revisiting that Nagging Question of Social Security's "Solvency"

One of our periodic financial planning pressure points involves the sustainability of Social Security. Each year, the trustees of the Old Age, Survivors, and Disability Income (OASDI) Trust Fund try to pinpoint a moving target: the year in which the Trust Fund's "assets" will be insufficient to support the payment of full projected benefits.

The trustees' latest report sees Social Security outlays exceeding its income in 2020, and goes on to project depletion of the Trust Fund by 2035, necessitating some adjustment in benefits, payroll taxes, or the law itself. This sounds scary, but it might help to understand that Social Security's putative day of reckoning is more of a legal obstacle than a financial brick wall.

When Social Security was established in 1935, it included a provision authorizing the use of *general* revenues if needed to supplement the payroll taxes specifically designated to finance benefits. As part of several significant amendments in 1939, Congress repealed that provision, underscoring its view that Social Security should be self-supporting into the future.

That is why the Trust Fund exists: to track the extent to which those payroll taxes have exceeded benefit payments (plus accrued interest on that excess), which provides the *legal* basis for paying benefits in excess of contemporaneous payroll taxes. Rather than being "paid" from general revenues, they are "covered" by redeeming the "special-issue" (non-negotiable) U.S. Treasury securities that comprise Trust Fund "assets."

In the real world, the federal government runs a cash operation with large annual shortfalls. Excess payroll taxes are used as received to meet other government obligations. When current payroll taxes *do not* cover current benefits, the difference is borrowed in the credit markets just like the rest of the federal deficit. "Redemptions" from the Trust Fund are accounting entries, writing down the *legal* cushion that the Trust Fund actually represents.

You may recall President George W. Bush trying to explain all this to us back in 2005. He was pushing the idea of giving folks the option of funding their own personal accounts under the program. Mr. Bush may not have been the most articulate or persuasive proponent of that concept. Then again, real candor about how Social Security works has been hard to come by on *either* side of the political aisle. ■

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Tapping 529 Plans to Good Advantage

A new school year is here – time to start spending the money in that 529 plan, right? Perhaps, but first comes the question of which costs qualify for *nontaxable 529* withdrawals. Then you want to check other ramifications of spending from one or more of those accounts.

Tapping a 529 for *nonqualified* expenses may incur tax and penalty, depending on investment growth in the account, state tax deductions for past contributions, etc. However, **most major college outlays** *are* **qualified**, including:

• **Tuition** at accredited institutions – Study abroad may qualify, especially if a program provides college credit. The 2017 tax act added private elementary and secondary school tuition (but only tuition) as a qualified 529 expense, up to $10,000 per calendar year.

• **Dormitory or sorority/fraternity room and board** for students enrolled at least half time at an eligible college – Off-campus living also qualifies up to amounts stated in the college's cost of attendance.

• **Textbooks, supplies**, other required reading materials, and basics such as pens, paper, and calculators.

• **Computers and peripherals**, including tablets, laptops, printers, internet access, and core software.

• Resources and equipment to meet a student's **special needs or disability**.

Withdrawals from a 529 trigger a 1099-Q showing the amount to be included on the recipient's tax return. For 529 distributions paid directly to a student beneficiary or an institution, the beneficiary receives the 1099-Q. The 529 owner and/or beneficiary should keep receipts for any associated expenditures.

Strategies for Spending

The full complement of planning considerations bearing on ownership and use of 529 plan assets are too numerous and family-specific to cover comprehensively in this space. But the effect on *financial aid eligibility* is critical and time-sensitive.

Most colleges use information from the Free Application for Federal Student Aid (FAFSA) as a basis for aid eligibility, while a few also require the College Board's CSS Profile. A 529 plan owned by a dependent student or parent counts as *parental* assets, which only marginally boost the Expected Family Contribution (EFC). *Grandparent-owned* 529 assets are *not* reported on the FAFSA, but may be required on the CSS Profile.

Other *student-owned* assets such as a custodial account can trim the aid package by 20% of those asset values. Income on the student's tax return, including interest, dividends, and capital gains, is assessed at 50% when calculating the EFC.

Withdrawals from a parent- or student-owned 529 are not reported on the FAFSA and do not affect subsequent financial aid. But using assets form a *grandparent-owned* 529 is treated as untaxed income to the student. That can materially lower aid eligibility the following year.

The interplay of these moving parts calls for expert analysis as early in the process as possible, with regular reviews over the course of a student's college years. Starting a little late is still better than never. ■

Tips for Managing Your Credit Score

Accessing credit on reasonable terms is a key factor in managing our financial lives. A credit score is considered by mortgage lenders, credit card issuers, cell phone carriers, etc. What goes into that number? Whatever can help lenders manage *their* risk while greasing the skids of a twenty-trillion-dollar, credit-based economy.

As a starting point, your credit score is just a three-digit indicator of your history and capacity for handling debt. It is not your full report, which details your credit-based accounts, current and past payment patterns, etc.

Age, income, employment status and history do not *directly* affect your score, but they may influence lenders offering some types of credit.

Different credit reporting companies score differently, but FICO scores are most common. They range from 300 to 850, with 750 or better easing your access to credit along with more favorable rates and terms.

Timeliness matters. Lenders are leery of any tendency to be tardy with payments. FICO cites it as the biggest factor (35%) in a credit score.

And so does moderation. The level of outstanding debt is the second-largest factor. Experts suggest keeping balances on revolving debt below a third of applicable limits and paying down large credit purchases more quickly. If you fear that you may be over-extended, your financial advisor can help evaluate your debt and set a strategy for managing it effectively.

How long you've used credit and the age and usage of various accounts represent about a 15% factor in your score. It takes time to build a credit history, but responsible use and timely payment practices can start day one.

Opening too many new accounts in a short time can be a concern. However, if you are simply rate shopping, only the account on which you actually take out the loan should show up on your credit report.

Lenders look for an ability to manage different *types* of credit (credit cards, retail accounts, car loans, mortgages, etc.). Don't open accounts needlessly, but experience across multiple categories can boost your score.

Feel free to check your number; it does *not* lower your score. Primary credit bureaus such as Experian, TransUnion, and Equifax may charge a fee, while online services offer a free check to grab a bit of your data. Bank and credit card companies may offer customers a free credit score check. ■

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Markets are forward looking, but with imperfect vision. In the here and now, Greece's economy is still 25% smaller than before the 2008 financial crisis. The nation's outstanding debt is 180% of its gross domestic product. High unemployment, suffocating bureaucracy, and onerous tax rates persist. If reform were easy, it probably would have made more progress by now.

Greece is a member of the EU, but it is deemed an *emerging* market by major equity index providers. That's probably a good thing. Those who would partake of the country's comeback Kool Aid might best limit themselves to small sips. ■

Sing Hallelujah, Come On, Get Happy

Based on a recent study conducted by San Antonio's Frost Bank, *optimism* is the key to better financial health and management. Did you ever doubt it?

Frost Bank engaged positive psychology expert Michelle Gielan and the researchers at TRUE Global Intelligence to query more than 2,000 Americans, testing the premise that those who face life's challenge with a more positive outlook can, on balance, realize life-enhancing results.

We'll spare you all the survey's self-fulfilling statistics. Suffice it to say we should all cheer up. ■

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A Brand New Theory...

without sparking an inflation conflagration at some point? That is the essence of "Modern Monetary Theory" (MMT) – the idea that a nation borrowing in its own currency can more or less spend to its heart's content. Money can always be printed to service the debt, right?

MMT may be one of those theories that works fine until it doesn't. At their best, financial markets exist to steer capital to promising enterprises and prudent governments at prices and terms freely set by a diverse army of informed market participants. At some point, if money itself is virtually free – if there is no real quantitative or qualitative limit on the ideas and initiatives that can find financing – what prevents the worst from crowding out the best? What return, if any, could we expect on financial assets?

Reaching back a bit farther than the last few decades, history is replete with the record of great nations whose economic vitality and contributions to human progress languished once they abandoned some semblance of fiscal discipline and practicality. So far, simply printing more money has not proven to be a panacea. ■

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