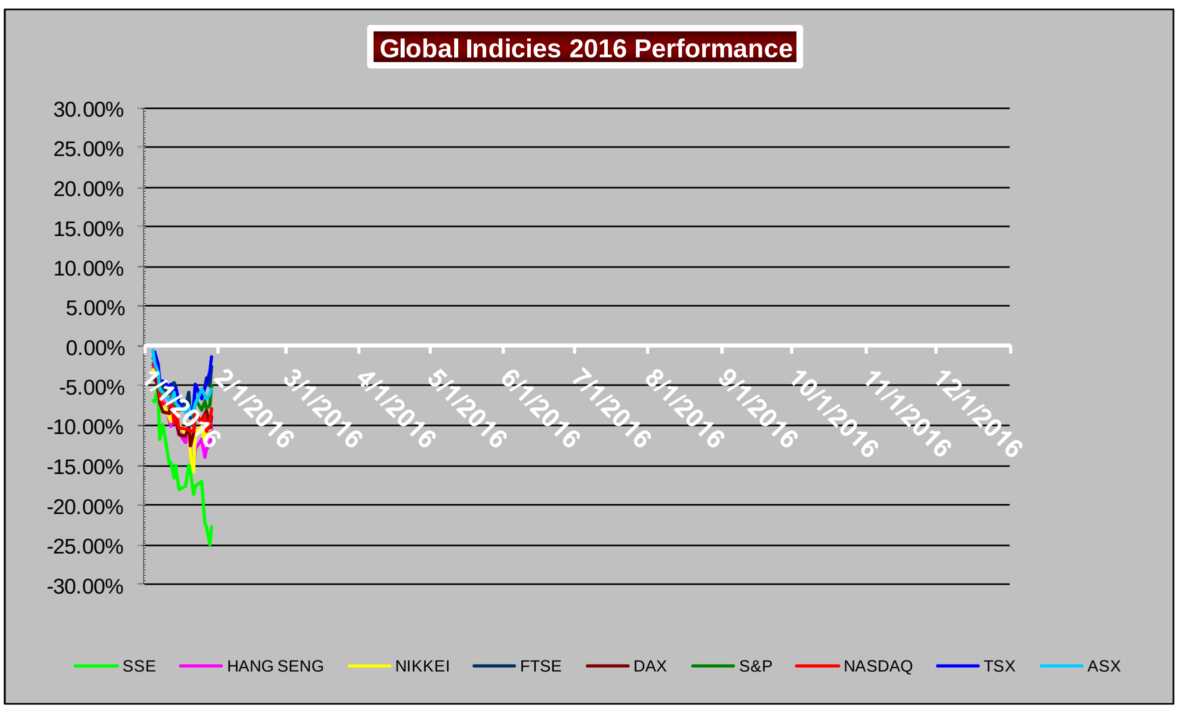
GDB February 2016 Newsletter

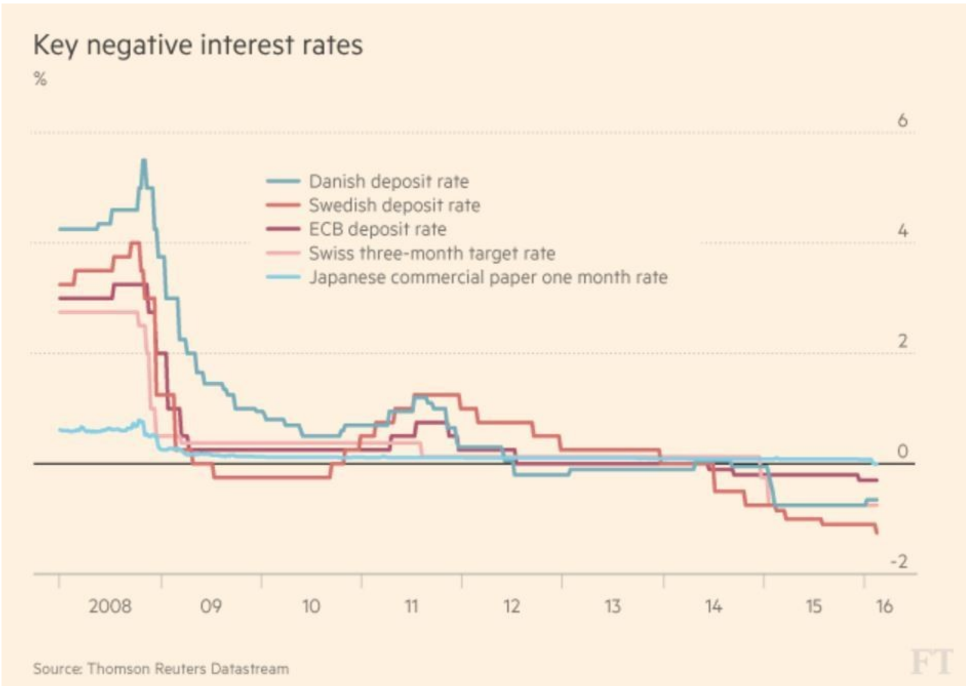
Monthly Market Summary:

2016 January Market Activity		
SSE COMPOSITE	***2,737.60***	-801.58 (-22.65%)
HANG SENG	***19,683.11***	-2,231.29 (-10.18%)
NIKKEI 225	***17,518.30***	-1,515.41 (-7.96%)
FTSE 100	***6,083.80***	-158.50 (-2.54%)
DAX	***9,798.11***	-944.90 (-8.80%)
DOW	***16,466.30***	-958.73 (-5.50%)
S&P 500	***1,940.24***	-103.70 (-5.07%)
NASDAQ COMPOSITE	***4,613.95***	-393.46 (-7.86%)
ASX 200	***5,005.50***	-290.40 (-5.48%)
TSX COMPOSITE	***12,822.10***	-187.90 (-1.44%)



Investment Themes:

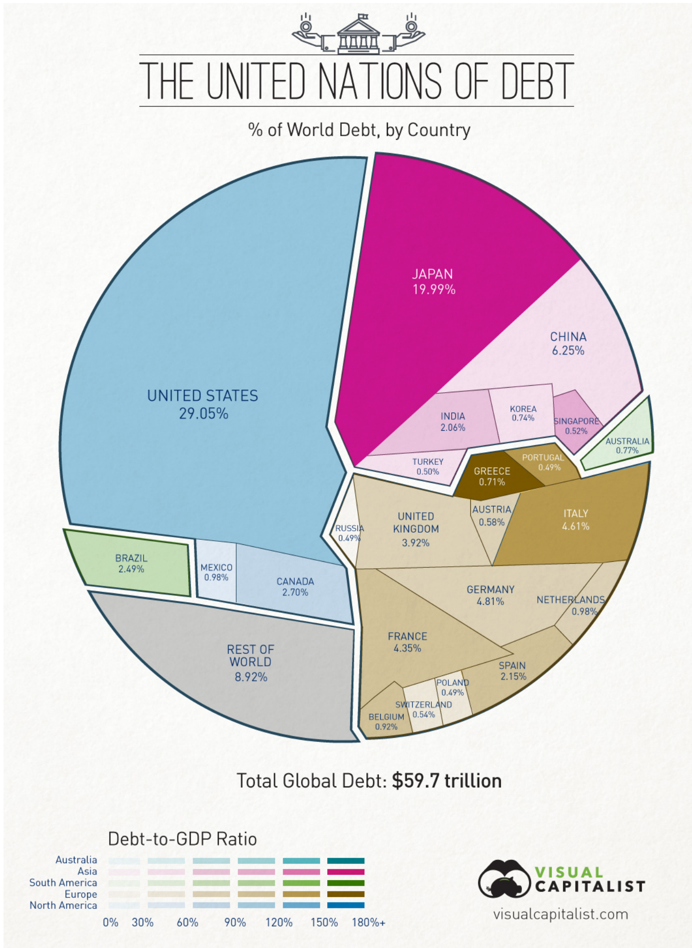
At the end of the last month, Bank of Japan joined the rank of other central banks in Europe to bring its interest rate into negative territory. Switzerland, Sweden, Denmark, the Eurozone and now Japan, regions that represents a quarter of the global economy, and one-third of developed markets stocks are now experimenting with negative interest rates as conventional monetary policy tools become less effective.



The logic behind the negative interest rate policy is such policy forces banks to boost lending as excess reserve kept at the central banks will now cost money instead of receiving interests. This in turn, erodes banks' interest margins and makes them less profitable. As an illustration, prior to negative interest rate, a bank would offer loans at 3% and receive 0.5% on the deposits for money not loaned, so the overall interest revenue is 3.5%. Then, assume the same loans are offered at 3% and now the bank has to pay 0.5% in interest on their funds not lent, the profit from interest decreases to 2.5%. To get the bank to the same profitability position as prior to the negative interest rate environment, the bank can: a) absorb the -0.5% cost and loosen its underwriting policy to increase the volume of loans while keeping lending rate constant at 3%. This essentially increases the credit risk of its portfolio; or alternatively, the bank can pass on the -0.5% cost to its clients by charging a higher interest rate on its loans. However, this erodes demand. So either way, the bank is negatively affected. This is why stocks in the financial sector, not energy, are now the leading sector that contributes to the global MSCI World Index decline.

Many market commentators have focused on how negative interest rate policy is a sign that central banks are running out of ammos in their fight to stimulate the economy. In our opinion, there may be a hidden agenda by the monetary authorities to address a much larger problem in the financial system in many of the developed economies. Since the financial crisis, the interest rates for many developed economies have been lowered and kept at near zero. Yet, if we take away the growth in financial asset such as the stock, bonds and real estates, the underlying economies of US, Europe, Japan have mostly treaded water over the last few years. So why would central banks jeopardize their credibility and experiment with unprecedented negative interest rate policies when they know or should know further reduction in interest rates at current levels will have marginal impact to the economy. After all, the authorities have been engaging in zero interest rate policy for seven years since the financial crisis, and Japan's interest rate has been kept at near zero for 17 years?

Ponder for a moment who are the biggest beneficiaries when interest rates slide to zero and beyond? Of course, the borrower who are able to borrow at these rates. And who are the biggest borrowers in the world? Not you and me, not the corporations, but the sovereign governments. According to a Bank of America research from 2015, USD 6.3 trillion in government bonds were yielding less than 0%, and a further USD 20 trillion were yielding less than 1%. This means the combined debt that yields less than 1% now represents 40% of the total government debts in the world.



So for these heavily indebted countries, lower and even negative interest rates would mean lower debt servicing costs; in addition, reduced refinancing costs when their old debts issued at higher interest rates mature. We would go even go a step further to speculate that their central banks need to artificially suppress the interest rates at low levels or even negative territories so that these countries don't run into serious financial strains just to service their debts.

Illustrated by the interest rate sensitivity analysis in the table below, we can see that a small percentage increase in interest rates will see doubling of the percentage of tax revenues going into servicing these debts. And if rates were to normalize to 5%, 20% to 30% of total government tax receipt will be required to just pay interests, and for countries like Japan, debt servicing cost will consume 100% of tax revenue!

					Interest Rate Sensitivity				
(In trillions)	**Public Debt**	**in USD**	**Tax Receipt[1]**		*+1%*	*+2%*	*+3%*	*+4%*	*+5%*
Eurozone	€ 9.7	$ 10.8	€ 2.6	*Incr. in interest*	€ 0.10	€ 0.19	€ 0.29	€ 0.39	€ 0.49
				as% of Tax Receipt	3.7%	7.4%	11.1%	14.8%	18.5%
JPN	¥ 1,245	$ 11.1	¥ 64	*Incr. in interest*	¥ 12	¥ 25	¥ 37	¥ 50	¥ 62
				as% of Tax Receipt	19.5%	38.9%	58.4%	77.8%	97.3%
US	$ 19.1	$ 19.1	$ 3.0	*Incr. in interest*	$ 0.2	$ 0.4	$ 0.6	$ 0.8	$ 1.0
				as% of Tax Receipt	6.4%	12.7%	19.1%	25.4%	31.8%
Total		**$ 40.9**							

(1) Excludes social benefit contributions.

Using stimulating the economy as a disguise, the central banks can lower the interest rated to create breathing room for their respective governments and even create money out of thin air by pushing interest rates into the negative.

However, who would want to lend money to these governments at negative interest rates? Most investors won't, especially if rates reverse course and increase during the holding period resulting in capital loss on the price of the bond. Well, the central banks that slashed rates can also step in as the buyer of the debt and hold them on their balance sheet until maturity. In essence, this is just another innovative form of quantitative easing. The central banks will absorb all these existing debt from private sector players so their governments can refinance the debt at favorable lower rates. At the time when these debt matures in the future, hopefully there won't be a need for their governments to issue the same amount of debt, thus, rolling them off the books slowly.

With the financial engineering above, the heavily indebted governments in Europe and Japan have effectively masked their true intentions of adopting negative interest rate policies. By hiding behind attempts to stimulate the economy, they are able to effectively refinance their massive debts at arbitrarily attractive rates dictated by their monetary authorities.