



Are ultra-low interest rates the new normal?

Highly unlikely

In a previous comment (*Too low for too long*, 7th November) I looked at the potential risks associated with keeping interest rates at current, ultra-low, levels for long. Towards the end I noted that the argument assumed that current interest rate levels are abnormally low. If so, interest rates will at some stage normalise – and there will be a bond bear market.

However, could current interest rates be the new normal? Obviously, if that were the case, investment strategies would need to be adjusted. Not long ago, the suggestion that ultra-low interest rates could remain for years to come, would have been quickly rejected. Most central banks stress that current monetary policy is unusual and unconventional and that, as soon as possible, there will be an exit strategy, for which they are even now planning. And yet, there are some straws in the wind that make it worth investigating the issue. Notably in the United States, where the Fed last week tied its exit to unemployment falling below 6½%, which was generally interpreted to mean mid-2015 (I disagree; see the comment *Less than meets the eye*, 13th December). As if that were not enough, Janet Yellen, the Fed Vice Chair, has implied that interest rates should really remain where they are until 2016. The ECB's Governing Council at least discussed cutting interest rates at its December meeting (allegedly, the majority in favour was overruled by Messrs Draghi, Asmussen, Weidmann and Cœuré, but recent data remains weak and a repo rate cut in January is looking likely). In the UK, the incoming Governor of the Bank of England, Mr Carney, has hinted that it may be desirable to move away from the Bank's inflation target to targeting nominal GDP. In both Sweden and Australia, the central banks retain a bias towards easing – although it should be noted that, at 1¼% and 3% respectively, their policy interest rates are on the high side by current standards.

On the other hand, the Bank of Canada (Mr Carney again) has returned to hinting that that the time to withdraw some of the monetary stimulus is approaching; and further easing in China looks less likely if the recent uptick in inflation is a change of trend. Moreover, the *Financial Times* reported on 10th December that fixed income hedge fund assets are overtaking equity in value for the first time ever. That seems at least arguably sign that the fixed income bull market is over.

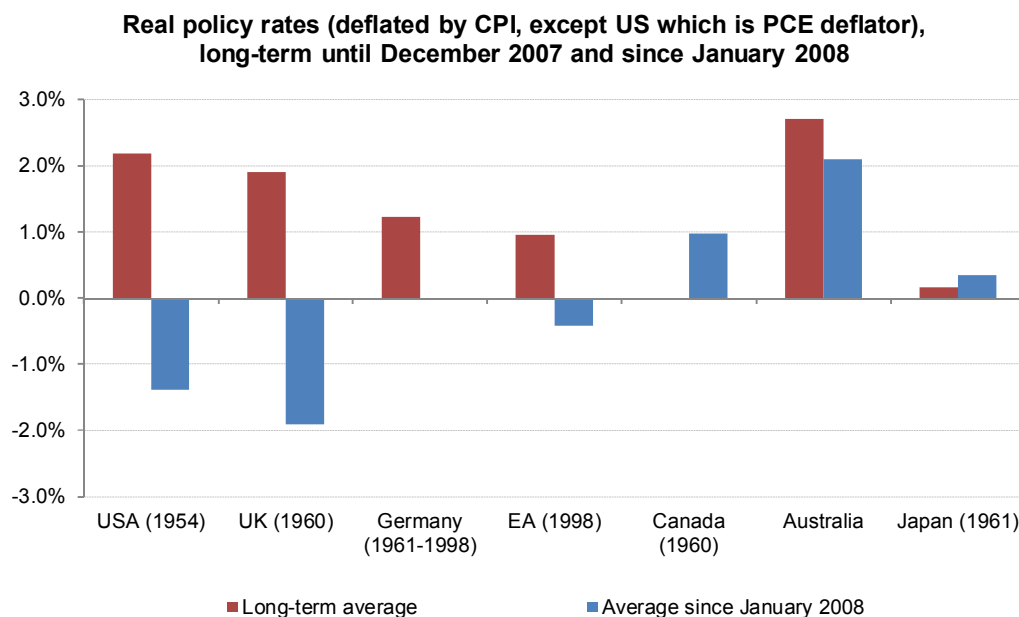
In truth, one-quarter point moves here and there are likely to make very little difference by now, except as signals of policy stance and attempts to convince markets that something is being done even as central banks exhaust one weapon after the other. But, of course, that is also important.

So, could current interest rate levels be the new normal? Looking at the past, it seems unlikely. The availability – at least the easy availability – of policy interest rate data varies. On the one hand you have the Bank of Canada, which gives data back to 1935; the Federal Reserve to 1954; and the Bank of England to 1694 (although the older data is perhaps not entirely relevant for an analysis of the current situation). But for most other central banks, easily available data begins in 1960 if you are fortunate; and

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from any investment positions taken.

later if you are not. The following chart and any reference to 'long-term average' will therefore mean since 1960 or 1961, unless otherwise stated, except for the US where it is since 1955.



The chart shows that, prior to the Great Recession, real interest rates in major economies were, as expected, on average positive and usually between 1% and 2%. Canada is a surprising exception, but it also illustrates one of the dangers when looking at the very long term, namely that policy regimes can change. During the Bank of Canada's time as an inflation-targeting central bank, the real policy rate has averaged 1.3%. Japan is also an exception. But this is because from 1961 to 1989 (when the Japanese bubble burst), the long-term average real policy interest rate was deliberately kept negative to weaken the currency. One effect of Japanese deflation has been to push up the real policy interest rate even as the Bank of Japan has kept the nominal interest rate at zero.

The argument that current interest rate levels are normal, must therefore rest on the assumption that growth rates will not only not return to the ones seen in, say, the past two decades, but that current growth rates will remain the norm as well.

However, the current situation is not normal. Households are carrying excess debt. They are deleveraging. As we know (see the comment *US rebalancing continues*, 7th December), this process has gone a long way towards completion in the US, less so in other countries, but it is going on. (There are exceptions, eg, Sweden and Canada, where households continue to pile up debt; but, if anything, that is

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from any investment positions taken.



an argument for tightening monetary policy in order to discourage the process, not the other way around). Governments are also – as we well know – attempting to deal with their fiscal deficits and debts. This too will one day be done – although clearly not as soon as one would wish.

So even if output growth rates won't return to those of the pre-crisis period, they should recover from where they are now. That in itself argues that interest rates should rise somewhat. Moreover, whatever current and future trend growth rates are, if real interest rates remain negative, output growth will eventually be above-trend. Sustained above-trend growth will at some stage lead to accelerating inflation. It will take longer if output gaps are massively negative, since a period of above-trend growth will be necessary to close the output gap, let alone open a positive one. But, if productive capacity has been destroyed in the Great Recession, negative output gaps may not be so wide after all. Significantly, if Chinese inflation – to take but one example – is indeed accelerating again, it is doing so when the economy is growing around 7-8% at most, implying that trend growth is rather lower than that.

One further point should be made about trend growth. The argument is sometimes raised that trend growth rates will be lower in most advanced (and indeed some emerging) economies because of adverse demographic developments. This is certainly true for a number of countries and history shows that little or no population growth is bad news for returns on financial assets. However, while Europe is facing very bad demographics, three of the world's largest economies – the United States, Canada and Australia – and a couple of smaller ones still actively encourage immigration, if qualified. They should not be affected by this argument, which therefore loses much of its force on a global scale, however true it may be for individual countries.

It is also important to be clear about inflation: There is no reason to expect a sustained surge in inflation in the near future. Broad money growth remains weak everywhere, inflation expectations (for whatever good they do) are subdued, and commodity prices are easing. However, sustained above-trend growth will ultimately be inflationary – and the risk is greater if decision-makers believe that trend growth is higher than it actually is, thus attempting to stimulate growth in excess of what the economy can cope with.

In spite of current talk of shifting central bank focus, it is unlikely that central bankers will be prepared to let inflation rise permanently, if for no other reason than that it would wreak havoc with their credibility for any target regime and that we already know what high inflation does to an economy. A more likely outlook is that – once they are convinced that recovery has taken hold – they will be, as they already are, keen to exit their unconventional policies, not least to shrink their bloated balance sheets. Moreover, keeping interest rates ultra-low carries the risk of encouraging government backsliding, which again raises inflation concerns.

Hence, we have to assume two developments. The first is that nominal interest rates eventually will rise; the second is that real interest rates also will rise. The latter could come about sooner, certainly so if depressed growth in the near term pushes some countries into deflation.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from any investment positions taken.



The two relevant questions are then, how far will interest rates go; and when will they begin to rise? No economy ever returns to pre-crisis normal. Even so, it is likely that policy interest rates eventually will revert to at least close to their long-run averages, bearing in mind that those averages include periods (notably but not exclusively the 1970s) when real interest rates were negative, sometimes very much so and for a long time. That in itself should be a cause for thought for investors looking beyond the very near future. For US real policy interest rates to move near their long-term average, would mean an upward shift of around 300 basis points (from -1.6% in November 2012 to +1.5%, slightly less than the long-term real average of 1.9%). Even for the euro area, the upward shift is around 200bps – but here interest rates are admittedly likely to remain low for longer. The second question therefore becomes more crucial, but also more difficult to answer. It will vary from country to country, depending on economic developments. However, bear in mind that once deleveraging is finished, balance sheets will again be healthy. While households may not be eager to borrow again the way they did before the Great Recession, the drag from debt servicing will be less. Increased household consumption is likely to boost corporate spending; while a cyclical upswing will seemingly improve public finances as well, giving rise to calls for ‘compensation’ for groups that suffered from austerity policies. Activity could therefore rebound fairly quickly once it gains traction.

None of this is likely to happen in 2013, which is likely to be a year of weak growth at best (eg, US) or outright recession at worst (eg, euro area). But by 2014, at least the US economy and perhaps some others as well, should be shifting into stronger growth. Lloyd Blankfein, the CEO and Chairman of Goldman Sachs has warned of investor complacency. While Mr Blankfein may not necessarily be doing God’s work, he has a point. Current interest rates are (or should be) supportive of both stocks and bonds. When interest rates begin to rise because economies are recovering, it will be on the back of better equity prices – but bad news for fixed income.

Gabriel Stein
gabriel.stein@steinbrothers.co.uk

Gabriel Stein is Managing Director of Stein Brothers (UK) Ltd and Chief Economic Advisor to OMFIF. The views expressed are his own.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from any investment positions taken.

Registered office: 45 Chesilton Road, London SW6 5AA. Registered in the United Kingdom, registration number 08186233.