Interest rate outlook.
7th October 2017
for clients of Puzzle Financial Advice (AFSL 230050)

When considering interest rates, we must consider:

- cash rates – set by the central bank
- bond yields, long rates (that is fixed rates) – which are determined by supply and demand in the market.

Why is this important?

- At the end of a cash rate rising cycle, it is extremely common to have a crisis or crash. See Appendix C.
- Most listed securities like shares and listed property, are priced of bond yields. As bond yields rise, a higher discount rate needs to be applied to determine the capital value (Net Present Value) of a listed share and listed property investment. So rising bond yields put downward pressure on prices of shares and listed property.

The Cash Rate.

- Chris Joye in AFR 22/10/2017 covers some of the issues fairly well.
  - http://www.afr.com/personal-finance/shares/hedge-fund-guru-warns-of-much-higher-interest-rates-20170921-gym5km
  - "The world's most important central bank is on track for three rate hikes this year, and has started the unprecedented process of unwinding its asset purchasing program – or tapering "quantitative easing" – which is having a devastating impact on interest rate sensitive sectors."
  - "The preternaturally dovish RBA, which blew an even bigger housing bubble with multiple rate cuts in 2016, now admits that the global economy had, in fact, reached a "turnaround" in 2016, embarking on a new upswing."
  - 'During the week the RBA's Luci Ellis exclaimed that there was a risk in falling "behind the curve in catching a change in economic momentum". Goldman Sachs's Andrew Boak observed that "Dr Ellis noted the current expansion was not 'a flash in the pan'", emphasising the importance for policymakers to stay ahead of the curve because, as Ellis said, "waiting until you are 100 per cent sure things have changed means waiting too long". Anyone with half a brain knows the RBA should be hiking right now, given it takes two years for cash rate changes to percolate through the real economy. If the number of people willing to work had not soared since last September, Australia's jobless rate would be 4.3 per cent today (coincidentally in line with the fully-employed US and UK economies), not 5.6 per cent. On pure financial stability grounds, there is a compelling case for a single hike soon – simply to signal to borrowers that the cost of capital must inevitably normalise off the crisis lows that the well-paid owner-occupiers in Martin Place have bequeathed on their brethren.'
  - 'The Fed's research implies this will only lift long-term rates by about 75 basis points spread over many years, which Gillespie characterises as "inconsequential". Yet Toohey arrived at a very different conclusion: a global unwinding of central bank asset purchases suggests "10-year bond yields in the US [will] rise 130 basis points by the time we enter 2019".'
- This article is also worth reading http://puzzlefinancialadvice.com.au/2017/AFR/170920_AFR_Interest_rate_rises_to_trigger_$1.6trn_debt_bomb.pdf

- **"ECB, BoE, BoCanada signal coming end of ultra-easy money"** 4th July 2017.
  - https://www.puzzlefinancialadvice.com/single-post/2017/07/04/ECB-BoE-BoCanada-signal-coming-end-of-ultra-easy-money
- The US Fed decided in their September 2017 meeting to start reducing its balance sheet.
  - https://www.washingtonpost.com/news/wonk/wp/2017/09/20/in-sign-of-u-s-economys-strength-fed-to-start-reducing-4-5-trillion-balance-sheet/?utm_term=.100dd1d51e29
    - 'The Federal Reserve said Wednesday that the U.S. economy is strong enough for the central bank to begin reducing its $4.5 trillion balance sheet in October, gradually unwinding a massive stimulus program started after the economy entered a severe recession nearly a decade ago. The Fed will start reducing its holdings by $10 billion in October and raising that amount gradually in the months to come. "The basic message here is U.S. economic performance has been good," said Federal Reserve Board Chair Janet L. Yellen on Wednesday. The U.S. economy keeps getting better, according to the central bank. Hiring is strong, consumers continue to spend and business investment is "picking up," the Fed said. It now projects 2.4 percent growth this year, far higher than last year. After the 2008 financial crisis and ensuing recession, the Fed took the unprecedented step of beefing up its holdings of government bonds and mortgage-related securities from $900 billion to $4.5 trillion in an effort to turn the economy around. Now the Fed believes the recovery is "on a strong track," so America no longer needs a big safety net.'
    - 'The Fed is trying to avoid disrupting this growth by outlining its plans clearly to avoid the type of uncertainty that tends to unnerve investors and rattle markets. The Fed released a plan in June to start small, unloading $10 billion worth of assets a month and then scaling up gradually over time until it is shedding $50 billion a month, starting in October 2018.'
    - A similar article. https://www.businessinsider.com.au/fed-statement-balance-sheet-interest-rates-september-meeting-2017-9?r=US&IR=T
- The US Fed is tightening monetary policy, the Bank of Canada is tightening monetary policy, the Bank of China is tightening monetary policy, the ECB is expected to start tightening monetary policy soon.
  - https://www.cfr.org/global/global-monetary-policy-tracker/p37726
  - Re US Fed – see discussions above about the US Fed starting to reduce it balance sheet soon. US Fed has already raised the Fed Funds target rate 4 times. https://fred.stlouisfed.org/series/DFEDTARU
  - Re the Bank of England. Comments from Jon Pain 16/9/17
    - "The Bank of England Monetary Policy Committee (MPC) changed their minds about the state of the UK economy, telling us that they are soon to raise rates. In fact they changed their minds about virtually everything, the UK economy, the global economy, the eurozone economy, UK wage growth...and the list goes on. And, perhaps, most significantly, Gertjan Vlieghe, a well known monetary dove on the MPC, didn't just change his mind, he performed a spectacular U-turn. Why? Because the facts have changed, that's why. Here is one of the more juicy bits from Vlieghe's speech. *"Until recently, I thought the appropriate response of monetary policy was to be patient, given modest growth and subdued underlying inflationary pressure. But the evolution of the data is increasingly suggesting that we are approaching the moment when the Bank Rate may need to rise."* http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2017/sep.pdf
  - Re the Bank of Canada. http://www.cbc.ca/news/business/rate-hike-impact-1.4276931
  - Re the European Central Bank.

        - https://www.dailyfx.com/forex/market_alert/2017/09/06/Germany-Piles-Pressure-on-ECB-to-Tighten-Monetary-Policy.html
            - "Just minutes later it was the turn of German Finance Minister Wolfgang Schaeuble, who said he respects the independence of the ECB but that everyone around the world wants a normalization of monetary policy as soon as possible."
        - https://www.cnbc.com/2016/09/07/interest-rates-european-central-bank-may-wait-for-federal-reserve.html
    - China slows credit growth.
        - Financial Times 14/August/2017 "China growth set to slow as credit tightens".
        - https://www.ft.com/content/4da80fce-80a9-11e7-a4ce-15b2513cb3ff?mhq5j=e6
    - The money printing era of major Western central banks seems to be coming to an end.
        - https://www.puzzlefinancialadvice.com/single-post/2017/09/26/Central-bank-money-printing-since-GFC

<u>Bond Yields.</u>

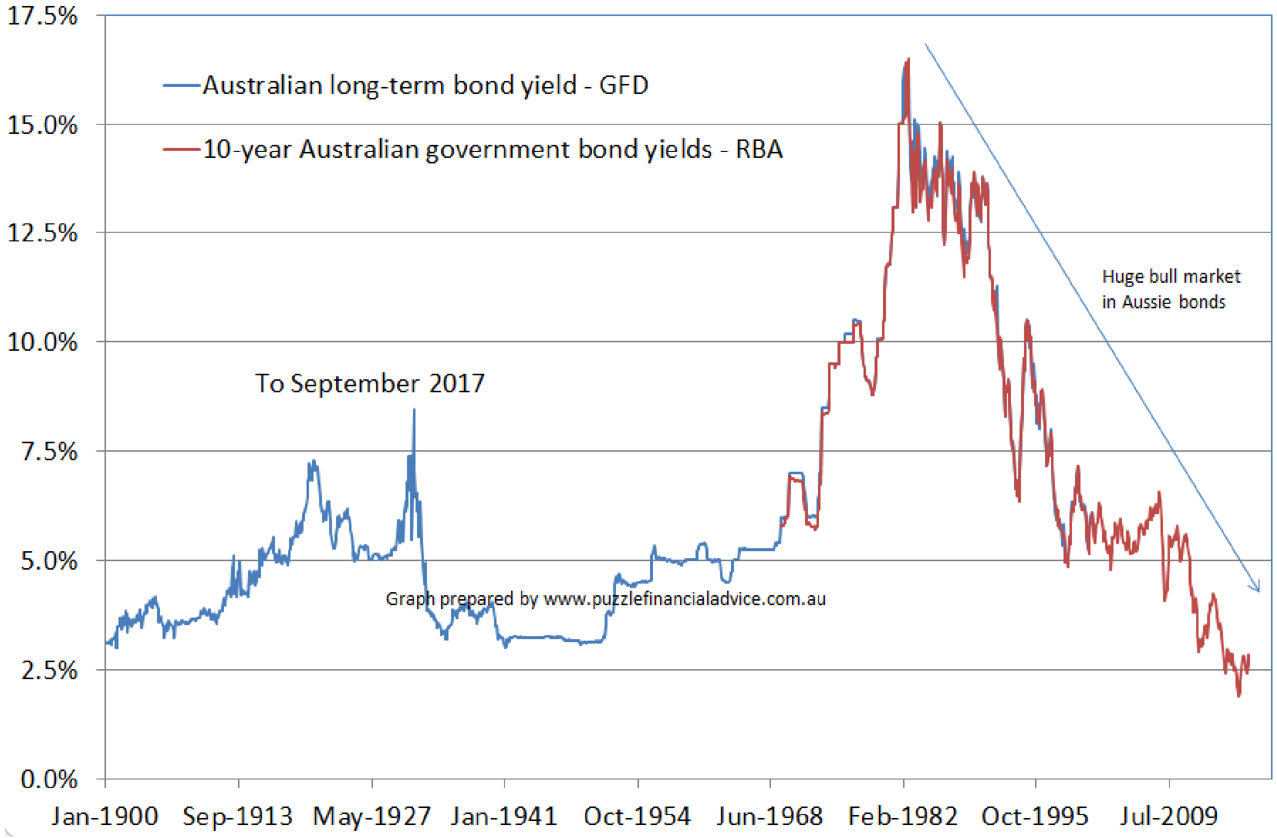
- The issue is best summed up by 2 factors:
  - **<u>As Andrew Clifford, CIO of Platinum Asset Management put it recently</u>**, over the last 10 years or so, the Anglosphere countries (eg UK, USA, Australia, Canada) have been running current account deficits (and large budget deficits) as a strategy to engender economic growth in light of the Global Financial Crisis. These deficits have been primarily funded by the countries with major current account surpluses – China, Korea, Europe.
    - https://www.platinum.com.au/journal/views/macro-overview/ 19/APR/2017
      - "Most readers would be well aware of the massive trade and current account surpluses that China has produced over the last two decades as it became the unparalleled provider of low cost manufacturing of goods. …. In the period post the Global Financial Crisis (GFC), the Eurozone has turned its current account deficit into a surplus in the order of US$403 billion, and South Korea's surplus has risen fivefold to some US$100 billion. These provide a useful point of reference for China's surplus of US$271 billion in 2016."
      - "Interestingly, though, while income inequality has resulted in substantial trade surpluses for China and, for that matter, Germany and South Korea, the United States saw the opposite outcome. To examine this issue we need to consider two important relationships that exist in all economic systems. The first is that a current account surplus will always be exactly offset by a capital account deficit. When China, Germany and South Korea run current account surpluses, they are exporting their excess savings via the capital account to economies that run current account deficits, such as the US, the UK and Australia."
      - "The export of excess savings by the surplus countries has been a key to many of the boom-and-bust scenarios seen around the globe."
      - "<u>A Possible Rebalancing May Be Under Way</u>". "In the longer term we could potentially be entering a period where a significant rebalancing of global current and capital accounts substantially changes the dynamics of global capital flows. In China, this will in part be a natural consequence of the consumer economy taking hold, but likely also requires reform that redistributes income towards the household and away from the state. In Europe and elsewhere, the surpluses may recede as cyclical recovery strengthens and the pressure builds for fiscal spending to redistribute income within these economies. Such a rebalancing would be a healthy outcome in aggregate for the global markets and economies; however, the removal of capital flows from areas that have unduly attracted capital (USA, Australia, UK, Canada) may result in some dramatic adjustments (price falls)."
    - https://www.platinum.com.au/journal/views/macro-update---june-2017/
      - "If this rebalancing is indeed underway, then we think there are potentially significant implications for Australian investors. Foreign capital inflows have long been a characteristic of the Australian economy. All of our investment cycles, whether it is the mining investment boom that is now coming to an end or the current cycle in residential apartment construction in the capital cities, have been in part funded by foreign money. At times foreign participation is clearly visible (as it has been in the case of property and mining), but it also plays an indirect and less conspicuous role via our debt markets and by funding our banking system. **There is nothing intrinsically wrong with this.** However, if the current account surpluses of the likes of Europe and China decline in the years ahead, we (Australians) would be faced with a choice between:

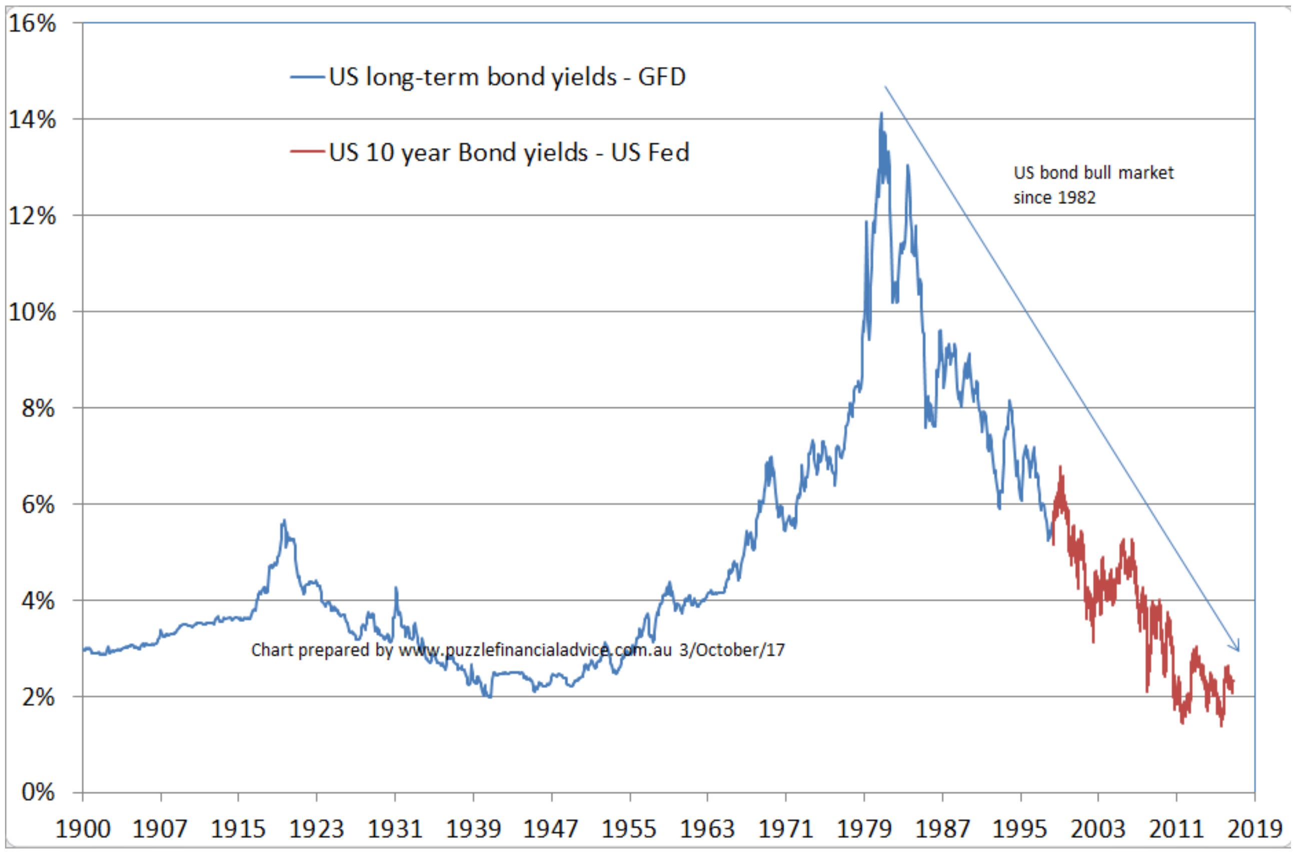
        - saving more (and reducing our dependence on foreign money),
        - competing for our portion of a dwindling pool of funds by raising rates of return for investors (i.e. higher interest rates), and
        - experiencing a fall in our living standards via a fall in the Australian dollar.
  - Jon Pain 30th September 2017 weekly newsletter.
    - "For some time now I have argued that reflationary forces are on the rise. Ten years on from the onset of a vicious credit crunch, across much of the developed world, credit is flowing again and the global economy is in the best shape we have seen in a long time. This leads me to believe that the world's leading central banks need to adjust their monetary policies to this new reflationary reality and are at significant risk of falling 'behind the curve.' In short, bond yields are too low and are set to rise materially over the next 12 -18 months."
    - "Each week we see more and more evidence that every region in the world is experiencing a rebound in growth. And yet in much of the world we still have Alice in Wonderland emergency monetary policy settings. Something has to give, and that something is bond yields, as investors wake up to the new reflationary reality, and its durability. In previous reports I have acknowledged the secular forces of disinflation, but we need to now acknowledge the robust cyclical forces that will drive wages, and broader measures of inflation, higher. "

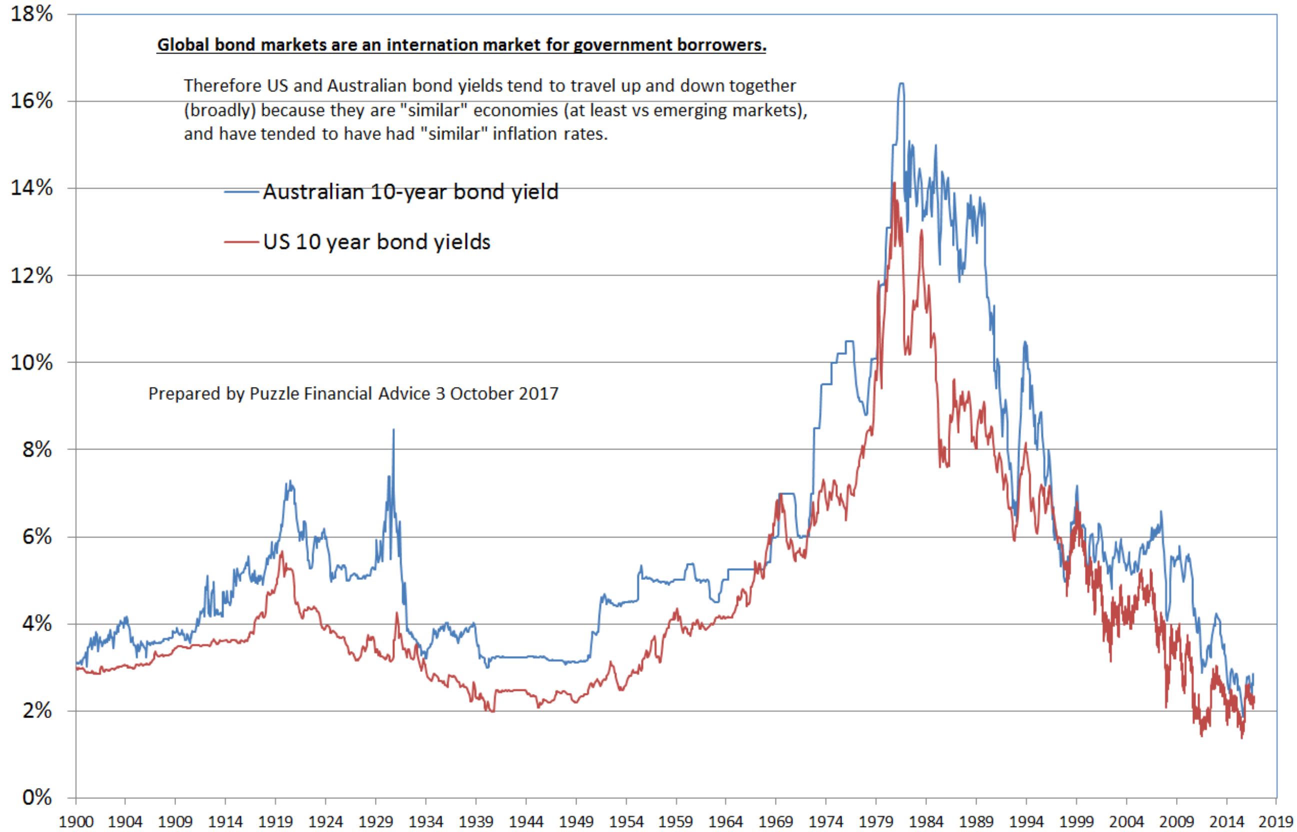
Possible Implications:

- Broadly, listed shares and listed property within a country are priced off the bond yields for a country, BECAUSE a listed security is valued is the discounted future cash flows from that listed security – with the discount rate being the risk-free rate (government bond yield) plus a delta which is determined by the then-perceived comparative risk of the listed security.
  - Therefore, rising bond yields tend to have a negative impact on the prices of most listed shares and property investments.
  - And yes, rising bond yields can also impacts the price of unlisted assets, though the impact depends on the nature of the investments in question.
- 20/9/2017 AFR "Interest rate rises may trigger $1.6trillion debt bomb."
  - http://www.afr.com/markets/equity-markets/interest-rate-rises-to-trigger-16trn-debt-bomb-20170920-gykyps
    - "The prediction of a higher cash rate coincided with a report from Capital Economics on Wednesday that said property prices in Sydney and Melbourne are up to 30 per cent over-valued but won't fall until the RBA starts to hike rates. Well, if the RBA is getting ready to hike it implies investors should get ready for a fall in house prices. So far the main reason why households haven't had to worry about their balance sheets, or wealth, is that house prices have gone through the roof. There's around $1.6 trillion of debt linked to the residential property market for investors and owner occupiers, but the value of all that property now stands at around $6.7 trillion. When rates rise, however, that debt number stays roughly the same but paying for it all goes up and if Capital Economics is right there will be a fall of 10 per cent in prices."
      - BB comment: As you know, I think that the impact on Australian house prices will be much more than the 10% indicated above.

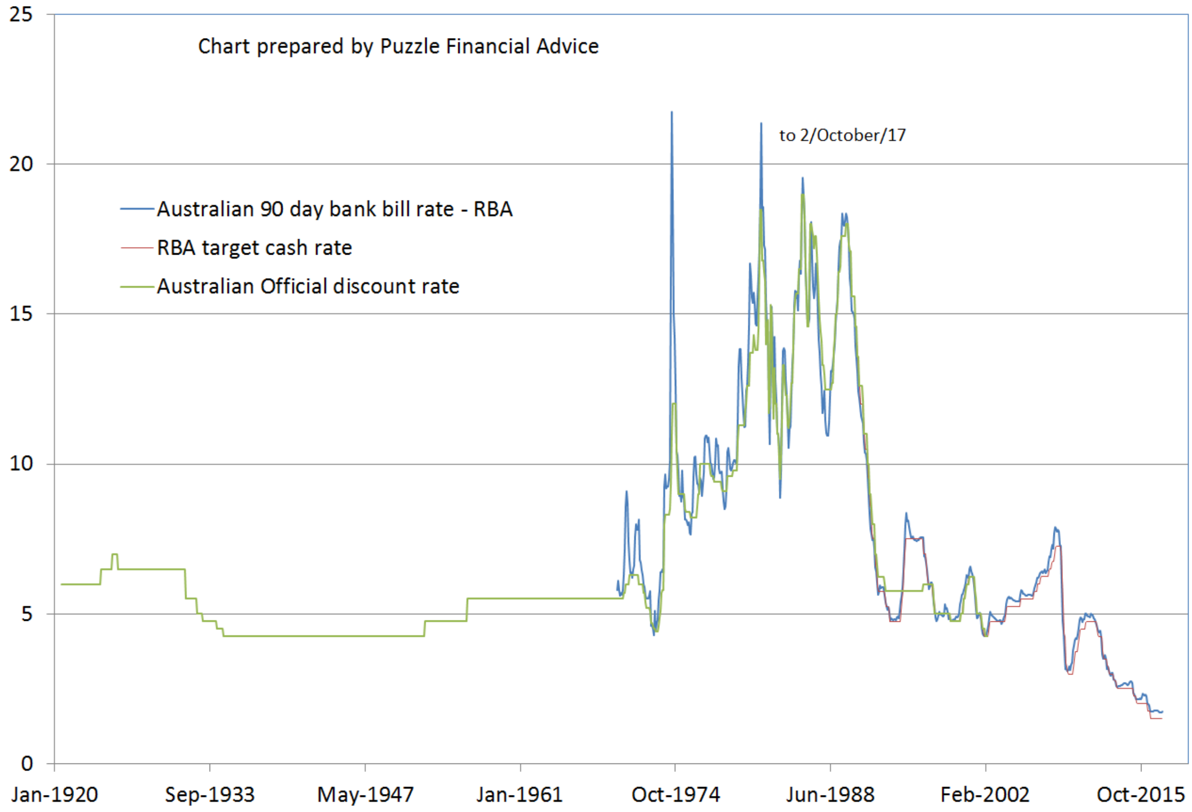
Appendix A. Bond yields in a historical context.

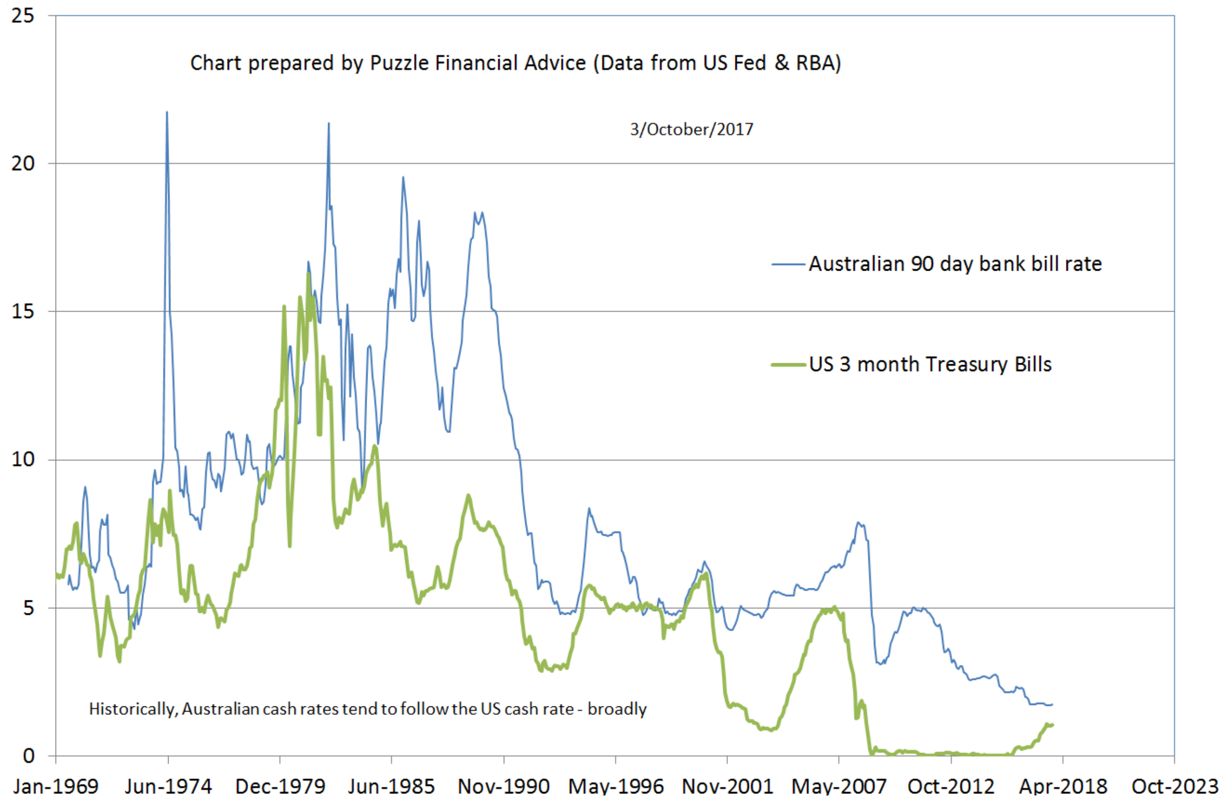




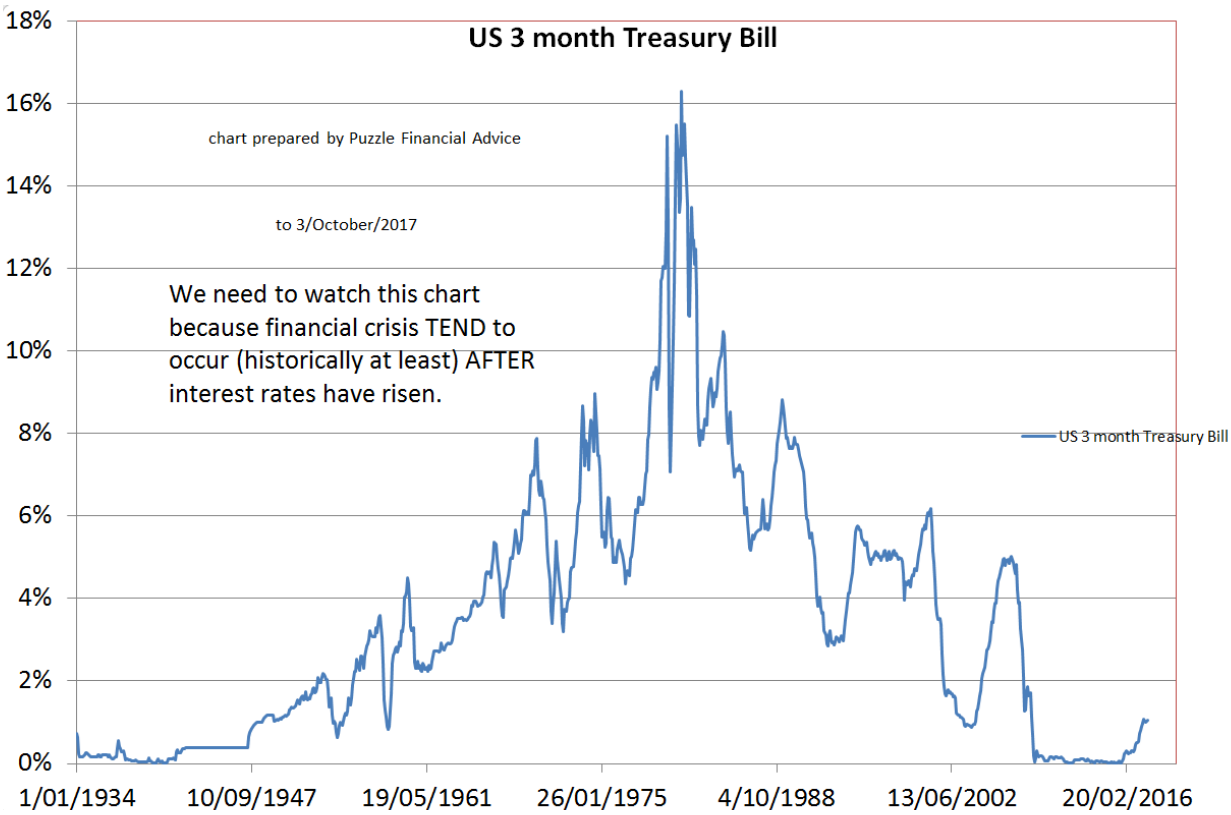

Global bond markets are an internation market for government borrowers.
Therefore US and Australian bond yields tend to travel up and down together (broadly) because they are "similar" economies (at least vs emerging markets), and have tended to have had "similar" inflation rates.
Australian 10-year bond yield
US 10 year bond yields
Prepared by Puzzle Financial Advice 3 October 2017
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
1900 1904 1909 1914 1919 1924 1929 1934 1939 1944 1949 1954 1959 1964 1969 1974 1979 1984 1989 1994 1999 2004 2009 2014 2019

Appendix B. Cash yields – historical context.





USA cash rates – 3 month treasury bills

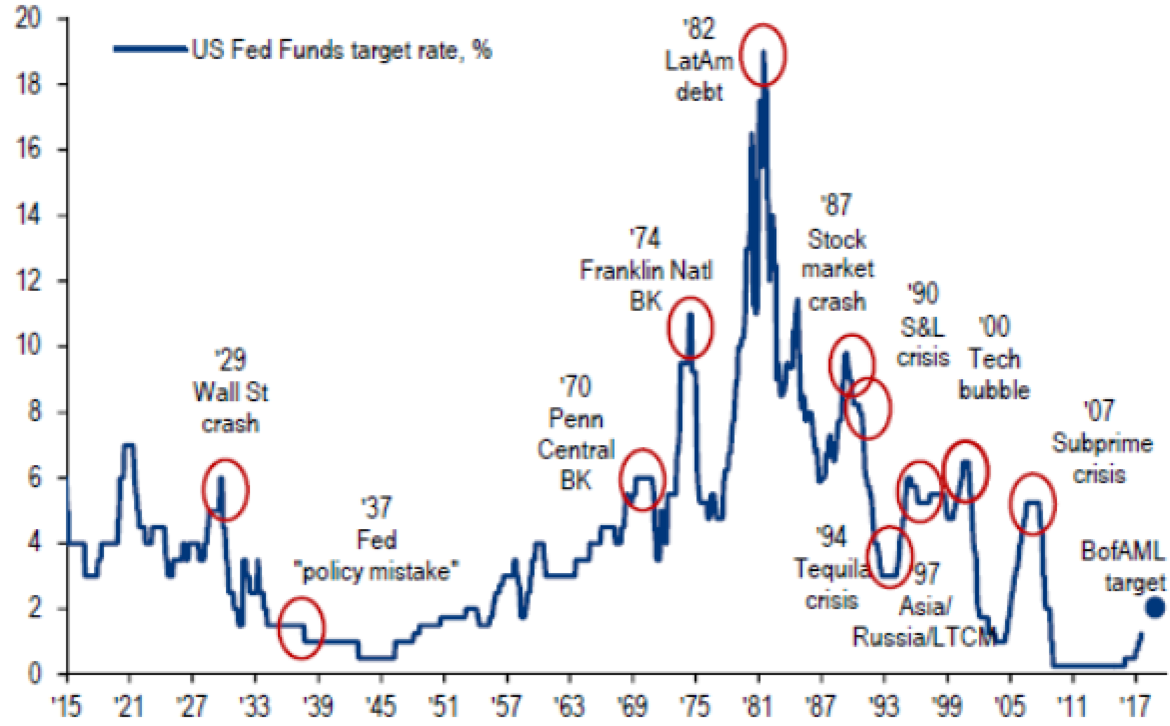


US Fed dot plot – where US Fed governors expect US cash rates to be over the next few years. https://www.bloomberg.com/graphics/fomc-dot-plot/ That is, on average US Fed governors expect US cash rates to be about 2.5%pa during 2019, up from 1.04% today. i.e. up 1.5% over 2 years.

Appendix C.

Financial crises have tended to occur at the end of a series of US Fed cash rate rises.

Fed tightening cycles typically end with an 'event'…

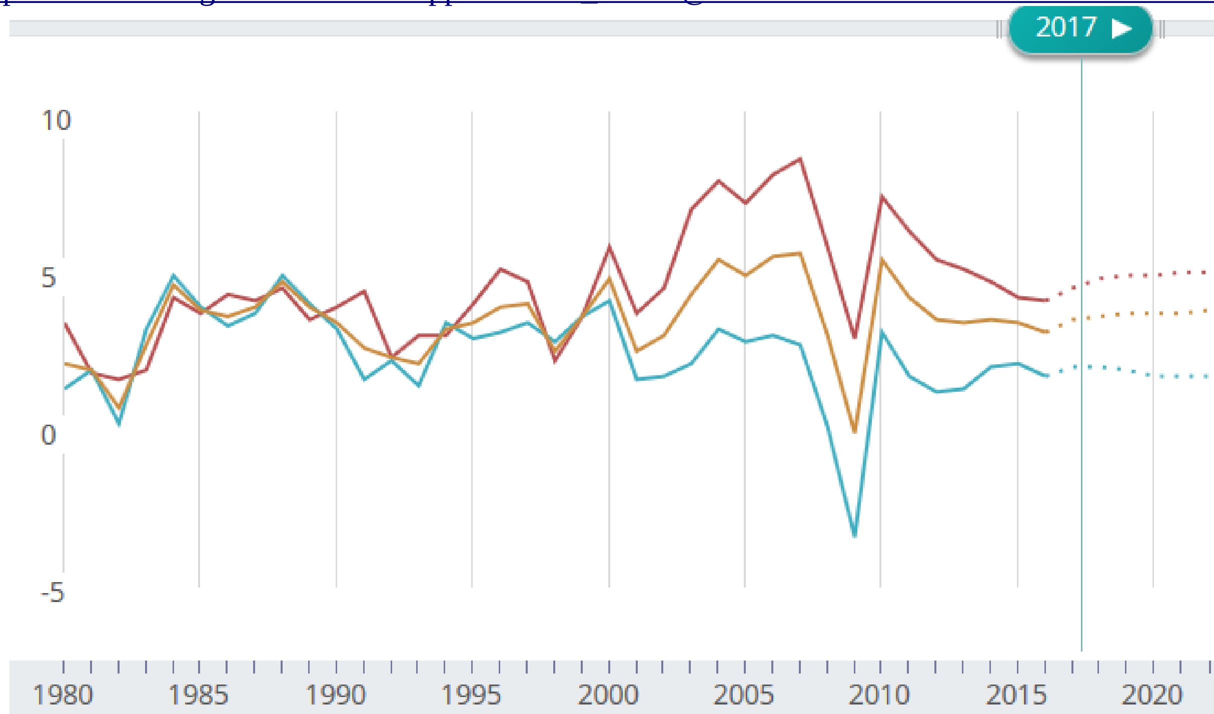


Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg

Appendix D. Global GDP growth rate.

As economic growth picks up, central banks tend to start putting on the economic brakes (raising cash rates and tightening money supply) to prevent inflation becoming problematic. We are not at that phase of the economic cycle in much of the world economy at this point.

http://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD



https://www.ft.com/content/07c1df06-a6ce-36f9-b323-22957f720f42?mhq5j=e6 4/Sept/2017
"Global growth still at record rates for this expansion"
Global GDP growth expectations increasing