Signature Global Roadmap: Third Quarter 2014

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Blowing bubbles: Implications from the Fed exit and a lower for longer monetary world

Having reached the halfway point of 2014 and peering down the back stretch toward 2015, the global economy and markets remain in rather decent shape. Indeed, the central premises from our first two Signature Global Roadmaps of 2014 (*Shifting tides: From synchronized global recovery to diverging growth paths* in the first quarter, and *Welcome to normal* in the second) continue to play out. We are seeing an overall pick-up in global growth as the global economy transitions to a more normal vs. crisis-driven background. Growth will be led by the U.S. and select emerging markets, including China. Europe faces structural challenges that will lead to sluggish growth, disappointing expectations, but will not push the Continent back into recession, while Japan's value-added tax hike in April ensured a roller-coaster ride for the economy in the first half, with any clarity on growth and inflation only likely to become visible through the fall.

Overall, I stick by my conclusion from the first quarter outlook in January that, "In summary, our global outlook for 2014 is decidedly sunnier than in recent years. However, we do expect that several squalls will emerge to roil markets and test investors over the course of the year. While the global economy remains fragile, it has and should continue to strengthen over the coming year."

Clearly, the weather-induced decline of nearly 3% for the U.S. economy in the first quarter was a bit more than just a squall, but the subsequent bounce in the second quarter has provided evidence of the slowdown's temporary nature. The resilience of both global economies and capital markets to the U.S. slowdown, and other events such as Russia's incursions into Ukraine and Argentina's default flirtations, leads us to conclude that the global economy is no longer as fragile as it has been in recent years.

This remains a positive backdrop for risky assets. The desynchronized nature of global growth means that the economy is advancing more slowly than in past recoveries, which in turn is helping to contain inflationary pressures. This is particularly true of energy markets, which have tended to be the growth constraint for the global economy. So while we do foresee an increase in U.S. interest rates, we expect rates to remain well below their previous cycle highs, as we will elaborate below.

The most important driver for the global economy and markets continues to be the trajectory of the U.S. economy and the Federal Reserve's monetary policy. June's employment report saw a jump in job creation to 288,000 and a fall in reported unemployment from 6.3% to 6.1%. This data was significantly stronger than expected, confirming that the U.S. recovery has rebounded from the self-inflicted fiscal cliff contraction of 2013 and the nasty winter weather impact at the start of 2014. While some of the strength in the current data reflects a catch-up from the first quarter dip, we do expect the U.S. economy to grow at close to 3% in the second half before slowing to a more sustainable 2.5% to 3.0% range for 2015. With the data confirming its expectation of an acceleration in economic activity, an improving labour market and firming inflation, the Fed has begun to spell out its expected exit strategy from its unconventional monetary policies.

U.S. monetary policy

Three key elements characterize the Fed's unconventional policy: 1) quantitative easing (QE), or money printing; 2) zero interest rates, and; 3) the size and trajectory of the Fed's balance sheet.

The first of these, QE, is well along the exit path, with the Fed tapering or reducing its monthly asset purchases by $10 billion per meeting. At its most recent meeting, the Fed announced that it would accelerate its tapering to $15 billion per month and end the purchases in October, rather than continuing at $10 billion and buying $5 billion at the final meeting to finish in December. While there is little economic implication between the two options, the fact the Fed wants to end QE earlier rather than later is important. It signals a desire to be done with asset purchases and to get on with stage two of the exit, which will entail raising the Fed funds rate.

This is the second aspect of the exit strategy. The Fed has effectively communicated that there will be a significant lag between the ending of QE and the start of rate increases. That interval will be dependent upon economic data, but is generally understood to be about six months. Hence, by ending QE two months earlier, the Fed is set to begin raising rates as early as next spring, rather than in the summer. Whether it occurs in April, June or July, expect rates to be rising this time next year. While the Fed is still inclined to err to the dovish side, another key motivation for raising rates is the need to build a cushion so that rates can be cut again during the next downturn. This is important for the Fed's ability to return to more conventional policy tools, rather than being locked into the unconventional policy world of recent years in which they are far less comfortable understanding the impact of their actions on the broad economy.

This is also the reason we expect the exit from the third aspect of unconventional policy to take a back seat to increasing rates. While I am sure the Fed would like to reduce the size of its balance sheet, it is far more interested in returning rates closer to what is believed to be the neutral rate.

Interest rates lower for longer

While there are significant technical issues around the concept, the question of what defines the neutral rate is an incredibly important issue for asset markets. It dictates where official interest rates will be heading, and ultimately represents the bedrock rate off of which all asset prices are valued. Currently, the Fed is indicating that 3.75% is the neutral level, down from a previous 4%. We believe the new neutral rate is actually lower and probably closer to 3%, and that the Fed's projections are likely to continue to drift down over time. The message for investors is: yes, rates are going to rise! But they will remain lower than previous cycles.

There are three key observations I would make that support this view:

1) This is not new; we have been in a falling rate environment for over 30 years.
2) High overall debt-to-GDP levels limit how far rates can rise.
3) Significantly lower rate structures in countries such as Germany (1.2%) and Japan (0.5%) will help anchor U.S. rates.

The first point is important. Since peaking in 1981, with the U.S. overnight rate at 20% and the 10-year Treasury yield close to 16%, interest rates have been in a declining trend for over 30 years. We believe this trend remains intact, and will remain so for another five to 10 years. The key characteristic of the rates trajectory is that while interest rates rise and fall with the economic/business cycle, each successive rise has been to a level below the previous peak, and each successive decline has been to a new low. We believe that this pattern will continue to play out over the current business cycle, with rates rising in the coming years as the economy gains traction, but to lower highs than the last cycle. In the last cycle, the U.S. 10-year Treasury yield reached a high of 5.3% in June of 2007 (the overnight rate also peaked around the same level). In the coming upcycle, I do not expect the 10-year rate to exceed 4%, and even north of 3.5% may be a challenge for the economy. By the same token, the Fed is expected to start gradually increasing rates in mid-2015, and while the pace of increases will be dictated by the data at the time, rates are unlikely to rise much higher than 3% in the coming years.

As mentioned, a key reason the Fed is determined to start raising rates is the need for some policy flexibility to lower rates in the next downturn. While it is too early to predict when the next recession will loom, assuming the rate structure is relatively flat in the 3% to 3.5% range at the time, we would expect the next economic downturn to be met with another cyclical low in rates. Although the overnight rate is unlikely to make a new low (we don't see negative rates in the U.S. at this point), longer-term rates certainly have the potential to do so as the all-time low in the U.S. of roughly 1.4% for 10-year Treasuries remains above the levels currently on offer in Japan and Germany. There is an equally plausible chance that the next decline in rates will be more moderate, indicating that the 30-year declining trend is bottoming within the current range. Both of these potential scenarios would portend a "lower for longer" scenario for interest rates. Regarding timing, assuming the current recovery continues to unfold slowly and rates rise accordingly, the next peak in the cycle and tip into recession could conceivably occur around 2017, followed by a recovery in 2018 (downturns unrelated to credit crises tend to be less than a year) and expansion well into the 2020's. This supports our notional timeline that rates may remain at low levels for potentially a decade. Clearly, this is not a forecast with a high level of conviction, but it illustrates that a decade of rates below 4% is not inconceivable. If so, the challenge for savers looking for a decent low-risk return is going to remain difficult.

With respect to the second point, while we have seen 30 years of falling rates, we have also witnessed 30 years of rising debt-to-GDP levels. With so much debt, it only takes a small increase in rates to have an impact. This is what leverage does – it amplifies the impact of a rate change on the underlying economy, so the higher the debt-to-GDP ratio, the bigger the impact of a rate increase. While the U.S. economy has seen some degree of deleveraging following the 2008 credit crisis, it has been minimal in comparison the overall steady debt increase seen in the prior build up. In part, this is because much of the private sector deleveraging was offset by an increase in government debt. With such elevated levels of debt, rates cannot rise as high as they have in past cycles without collapsing the economy. Simply put, if something cannot happen, it won't.

The third factor keeping rates lower reflects the very fungible nature of global capital flows, and here I see two aspects that will serve to anchor rates in a global setting. The first is the reality of what has been labeled the "global savings glut." Globally, there is an excess supply of capital. For instance, China has a saving rate close to 50%, Japan's aging population is sitting on one of the world's largest pools of savings, and many other countries have pre-funded retirement plans (just think of our own Canada Pension Plan with over $200 billion in assets). All of this surplus capital is looking for the best return and economics 101 tells you that when there is an excess supply prices will fall. For capital markets, an excess supply of capital means a lower return on that capital. The second aspect of the fungible nature of capital flows is that capital can easily move around the globe in search of the best returns. A saver in Japan today earns a miniscule 0.53% on a government 10-year bond, while German bonds pay only 1.2%! To both of these groups of investors, a U.S. government 10-year bond offering 2.5% will start to look pretty juicy. So while we think our interest rates are unsustainably low, they are in fact significantly above those of other major countries. At some point, the carry trade of funding in low-cost countries such as Japan and Germany and buying higher-yielding U.S. bonds will act as a brake on how much further U.S. rates can rise relative to other jurisdictions.

Our belief that rates can stay lower for longer is absolutely predicated on the notion that inflation is also likely to remain tame. We believe that the ongoing influences of globalization and technological change continue to exert disinflationary pressures and will ultimately introduce a more global nature to constructs such as potential growth rates and output gaps. This, coupled with the focus of central bankers on price stability, should keep inflationary pressures in check. Indeed, some regions such as Europe and Japan still face some risk of deflation, in our opinion. We are very cognizant of the risks to our outlook from inflation, but do not see the likelihood of a 1970's style inflationary spiral anytime soon.

Implications: Global yield grab into overdrive

If the above scenario of lower for longer rates does continue to play out in the coming years, it has significant implications for investors and asset returns. First and foremost, the "yield grab" we have been talking about for several years will go into overdrive. For many, the belief that rates would soon rise again meant that the implications from the yield grab were more cyclical in nature and would reverse as rates returned to their "normal" higher level. To the extent that markets increasingly view low rates as a more permanent structural issue, behavior will change. Investors looking for a 4% real rate of return (think of a 10-year government bond at 6% equalling 2% inflation plus a 4% real return), will be unhappy today with getting only 2.5% (2% inflation and a measly 0.5% real return), but they will also believe that in some reasonably short period of time markets will be back to offering a higher real return. As such, they can choose to either wait it out, or temporarily take on a higher risk profile to achieve a better return. They have not yet abandoned the belief that they can return to earning a 3% to 4% risk-free rate in the longer run. But if the risk-free rate is perceived to be permanently reduced to a 0% to 2% range, as we believe is possible over the coming decade, then the entire risk-return foundation of modern portfolio management is heading for a major smackdown.

To illustrate: assume that a pension plan or any pool of capital has been structured to require a real return of 4% over time to remain viable, and that government bonds are considered the least risky asset. To the extent that government bonds offer real yields of 3% to 4%, then the fund can invest the bulk of their assets in low-risk bonds and with a small allocation to riskier assets such as equities can easily meet their required return and remain solvent. That was the world we use to live in. If, on the other hand, we assume that real returns will range from 0% to 2%, then the greater the allocation to these "low-risk" assets, the greater the likelihood the fund will become insolvent. If low risk guarantees insolvency, then we are using the wrong definition of risk!

We are already seeing some signs that these trends are playing out as the yield-grab scenario goes into overdrive and spills across an ever-expanding range of assets. The first spillovers were from government bonds into corporate credit, across the quality spectrum into high-yield bonds, for which yields have recently reached record-low levels below 5%.

The drive for higher real returns can also be seen in the increasing allocation by large pension funds such as the CPP into tangible assets such as real estate and infrastructure. Here, the funds are acquiring long-duration real assets with strong cash flows that will keep pace with inflation. But this trend is also driving up prices on such assets to levels that are difficult to justify using public market costs of capital. We expect more of these assets will become privately owned as large institutional funds are able to outbid publicly-listed entities.

The impact from the yield grab implies that more assets are priced based on the current record low government rate structure as fears of a significant interest rate increase diminish. To date, most of the fixed-income or bond world is well down that path at record low absolute rates, but relative rates or spreads remain within historical norms. Increasingly, the impact is spreading into the realm of income equities such as REITs, as mentioned above. The one asset class that has yet to be significantly re-rated to a lower for longer rate structure is equities. In absolute terms, equities are currently priced at the upper end of historical fair value. But almost every other asset class has been re-rated well above historical levels in an absolute sense.

Today, our central case of a positive outlook on equities does not rely on rising valuations, but rather on equities performing more in line with expected earnings growth of 8% to 10%. However, we do see a fair probability that equities will continue to re-rate to historically expensive levels, reflective of the current low rate structure. Simplistically, the equity risk premium, which reflects the extra return over the risk-free government bond rate, remains elevated. The likelihood that valuations will continue to expand in the coming years definitely exists. While the journey to higher valuations will be rewarding for shareholders, it will also be quite uncomfortable. We all want to buy assets when they are cheap, and it becomes scary when there are no cheap assets. We are not yet there today, but we see a good chance that we could end up there given current global monetary conditions. For now, while volatility will be higher for equities, we expect equity holders will be rewarded for it.