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The Importance Of Low Long Term Rates To The US Economy, 1st of July 2013

The key observation around the US economic recovery is the important role that low long term rates have played. Equally it is noteworthy that up until the FOMC announcement asset purchases have provided an explicit ceiling above long term rates.

The behavioural effect of this has been simple enough for all to see, being namely:

- A reduction in long term discount rates and the risk free rate of return that made risk seeking behaviour desirable, and for professional money managers, essential.
- Investor behaviour has been driven by central bank activity (or the prospect there-of) rather than real economic performance.

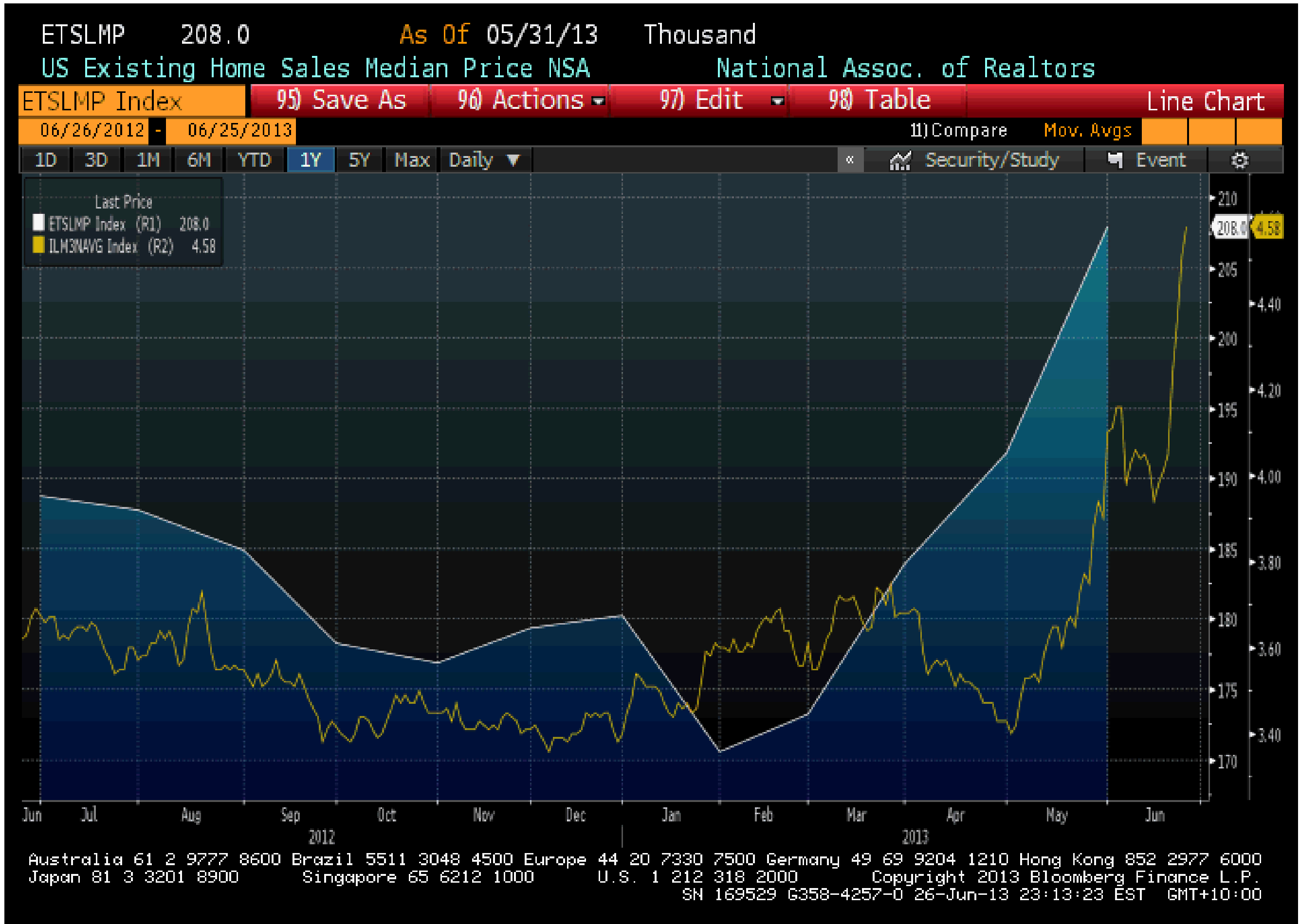
This in turn manifested itself in a number of ways:

- A change in correlations, especially between defensives and risk assets (bonds vs equities/credit have moved in unison).
- A collapse in risk term structures and solvency premium as investors stretched for yield (Investors have been willing to take less for longer in the name of higher yields).
- Low volatility in option premium across most asset classes (encouraged leverage to be taken in various asset classes).
- Gaming of the low rate environment by corporates (US companies have used low rates to increase buybacks and dividend payout ratios).

The net effect has been that low long term rate assumptions have underpinned risk taking and asset prices and have been central to the US economic recovery and perhaps more importantly highlights why the bursting of the US bond bubble (or a large increase in long term rates from current levels) is improbable.

We have provided the following charts to illustrate the leverage to low rates in the US economy:

- **US Property:** US 30 year fixed mortgage rates have sat at around 3.5% for an extended period until the last month and a half where they have increased to 4.5% (yellow line). The US median home price meanwhile (white line), will find it particularly difficult to rise under the duress of strongly rising mortgage rates.



Source: Bloomberg

- **US Share market:** The S&P 500 is trading at 10 year high's on a Price to EBITDA basis (orange line). This fact is not reflected in the P/E measure, the difference being the "I" , (the interest expense). The blue bars illustrate the dividend yield of the S&P 500. It shows a market that is very "cheap" from a price to dividend perspective. Very low interest rates have encouraged an increase in share buy-backs and driven increased dividend payout rates.
- Corporates have gamed the environment to deliver shareholder value by borrowing very cheap money and paying it out through buybacks and dividend.

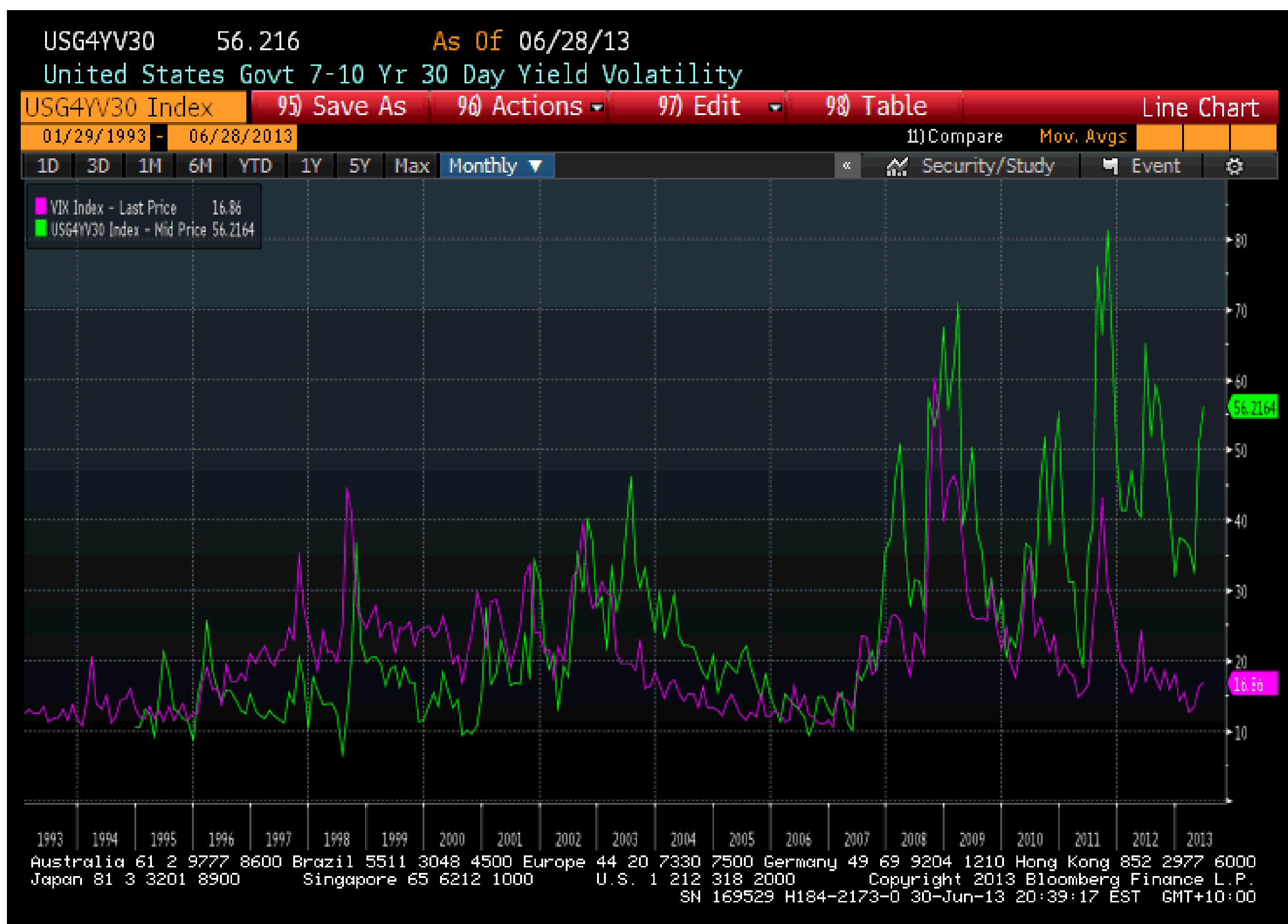
Source: Bloomberg

- **US CREDIT:** Despite the fact that all of the attention has been on US Bonds, the fact is that the low rate environment has seen investors take more risk for a smaller return.
- The chart below illustrates the premium paid for BBB corporate 10 year risk versus US 10 year government debt. The “spread” or risk premium, can act as a protective buffer against rate movement, however in an environment where the premium is small, risk premiums are more likely to be impacted by any change in interest rates. Rising rates will be bad news for US credit spreads, given that the US is primarily a fixed rate market.

Source: Bloomberg

The decision to remove the guaranteed rate cap by ending quantitative easing, doesn’t in itself ensure that we will imminently see higher longer term rates, however it does increase the probability, as the shape of the yield curve will once again become a function of economic outlook.

Consequently volatility in bonds has increased significantly (green line) versus other forms of risk (VIX is the pink line).



Source: Bloomberg

SUMMARY: Post FOMC a number of Fed members have pointed out that interest rates are likely to remain low well beyond the end of the asset purchases. Put simply , the view they are espousing is the average rate over the next 10 years did not justify the savage sell-off in bonds, especially given how benign inflation remains.

This may or may not be the case, however what is clear is that the US economy is ill-equipped to deal with a significant increase in long term rates in the here and now. At the other extreme however a continuation of the status quo (QE) is undesirable given the seemingly inefficient allocation of capital that it promotes.

We believe that the FOMC decision marks a deviation away from the status quo. We believe that this will manifest itself in a change of certain correlations, more specifically it will see the bond market driven by the expectation of US short term rates and the probability around the beginning of the tightening cycle, which means that the US economy will once again take primacy in driving US Treasuries (as opposed to expectations around QE).

For Australian Fixed Income investors, US treasuries continue to have a magnetic effect on the Australian bond curve, regardless of our own economic outlook, equally our credit market continues to be fundamentally impacted by foreign spreads, by virtue of our reliance on foreign capital. This makes what happens next across the Pacific fundamentally important to how Australian Fixed Income investors position themselves.

To discuss this information and how Realm Investment House is positioned in the current environment feel free to contact any one of the principles.

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