US rate signal may be broken

Dominic McCormick | Select Asset Management | 13 October 2014

It seems many investors are waiting for actual moves in US short term interest rates as the key signal to further increase the defensiveness of equity portfolios. After all, historically, short-term interest rates have been raised three or four times before previous major falls or crashes, on US markets at least. This was certainly the case in the lead up to 1987, 2000 and 2007/8. However, a valid question is this - have investors become too dependent on Federal Reserve tightening as the key indicator for predicting the next serious sharemarket weakness, particularly given the unique characteristics of the current cycle?

Perhaps this time really IS different - for there is a different interpretation of historical and current events that suggests greater caution now, even though short-term interest rates are not expected to rise in the US for almost a year and then only gradually with small 0.25% steps.

This different view starts with the contention that rises in US short-term interest rates don't actually "cause" major market weakness or crashes. Rather, the interest rates rises are primarily the response of central banks to growing pressures and stresses in the economic and financial system that are the ultimately cause of major weakness/crashes (e.g. lower risk premiums, rising inflation, leverage, excessive exuberance, etc.), although the precise triggers vary and are sometimes unidentifiable. Central bank actions "reflect" and are about attempting to temper these rising stresses in economies and/or markets. If this is the case, then historically what we have primarily had is a correlation story rather than a causal one.

It is likely that some of the complacency in markets in recent years may stem from this belief that sharemarket investors have little to worry about until the Federal Reserve has lifted short-term rates a number of times, supported also by the increasingly entrenched view of the omnipotence of central banks generally. This is often described in terms such as "the Fed has your back" or as the "Bernanke/Yellen put".

The problem today is that the basis for this historical interest rate/major sharemarket weakness correlation story may have partially or completely broken down.

Specifically, in response to the unusual severity of the GFC, debt overhangs and the overwhelming burden placed on monetary measures as policy levers (given the constraints on fiscal policy), there may currently be a fundamental disconnect between the current economic and financial market situation and the level of short term interest rates, in the US at least. For example, while inflation in the US is low at 1% to 2% per annum, it is still at levels historically consistent with short term rates of 2% to 3% per annum compared to the current near zero. The same could be said of a range of economic indicators such as employment/unemployment, particularly given recent improvements.

In addition, it seems central bank monetary policy has become increasingly hostage to attempts to target specific levels of a country's currency (the so-called currency wars as countries attempt to devalue their way to prosperity). This is clearly another factor impacting the level of short-term interest rates in ways that was less relevant in the past.

Thus, perhaps, in a more "normal" monetary environment policy environment, US short rates would already be at 2% to 3%, given where the economic and investment cycle is presently. The fact that they are not at that level may be providing a false signal to investors that there is still plenty of time for sharemarkets to rise and financial market exuberance to continue. However, the financial pressures and stresses that can lead to severe market weakness or even crashes may already be largely or fully in play (e.g. low risk premiums across many markets, record margin lending debt, investor complacency, etc.). The key difference this time is we may not have the "normal" central bank alerting process through official interest rate rises (or, at the very least, this process will be much more lagged than in the past). Further, little reliable guidance can be expected from longer term bonds rates given they have been distorted by Quantitative Easing (QE) and forced buying by investors chasing yield in a near zero interest rate world.

If we look across history and countries there have been many examples where sharemarkets have weakened markedly without significant central bank interest rates actions. Examples include Japan's equity market which fell dramatically several times in the 1990s and 2000s without a series of rising short term rates.

Of course, I am overly simplifying the situation. There is no doubt that actual higher borrowing costs as a result of higher short-term interest rates does have a direct negative transmission effect on many real and financial market participants. However, investors focusing on this as virtually the only driver of potential future sharemarket stress and weakness may be making a major mistake in the current unique environment.

Perhaps rising short rates will again occur before the next period of severe market weakness in the US. However, even if so, this may well just be another coincidence rather than the true cause of the weakness. However, in the meantime, we cannot rule out that markets could sell off severely anyway simply because investors suddenly decide that the environment is such that higher risk premiums are required to justify investment. The spark for this could be anything - from earnings disappointments to geopolitical events to credit issues. Maybe there is no spark - markets just run out of aggressive investors willing to bid up stocks. The signs of excess are already there to see, it's just that central banks, and especially the Federal Reserve, are not reacting to this because they have lots of other things to worry about (aborting the recovery, a higher currency, etc.).

Basically, we are living in an environment that is so unprecedented from a monetary perspective that relying on history for guidance may be very dangerous. Consider this:

1. We are starting from record low levels of short- and long-term interest rates;
2. These rates have been close to record lows for an unusually long period of time; and,
3. With an improving economy and positive inflation, there is a real risk that the US Federal Reserve, at least, is well behind the curve.

Even if we don't accept the contention that interest rate rises are a broken indicator of future sharemarket weakness, the fact that the current monetary environment is unique raises all sorts of dilemmas and challenges for investors, policy makers and the economy. Perhaps interest rates don't have to move much higher to have an adverse impact on the real economy and markets, given both the level of leverage and the conditioning to these very low rates. Perhaps central banks will have little power to battle any recession in the next couple of years given the starting point of already very low interest rates. And, even if they do again attempt to re-load policy with innovative monetary measures such as more QE, there is an increasing risk that next time they will lose credibility with market participants given past failures.

Australian monetary policy has been more normal than most countries to date but even the Reserve Bank of Australia seems to be slowly getting sucked into the pressures and policies of other developed economy central banks. It recently highlighted these risks in the system in its September Financial Stability Statement fearing "a sudden re-assessment of risk could lead to a sharp re-pricing of assets."

James Grant of Grant's Interest Rate Observer regularly makes the point that interest rates are just another price in the economy, albeit a very important one. He asks the question whether any central authority should be determining such important prices in a free market capitalist society. The risk is that policy makers interfering with market prices can sometimes lead to unforeseen and extreme consequences, some of which can be very ugly. Clearly, the full long-term implications of the developed world's central banks' extreme monetary policies of recent years are yet to fully play out. It seems the Federal Reserve's pre-set plan to end QE at the end of this month reflects, at least partly, such concerns.

Some of the challenges for investors in the current environment were very well summarised in a recent piece by David Hay of Evergreen Capital:

> "It is my contention that there are currently millions of fully-invested skeptics. They aren't bullish long-term – in fact, they believe the underlying fundamentals are alarming (with the usual perma-bull exceptions) – but they feel compelled by the lack of competitive alternatives to remain at their full equity allocation. Disturbingly, professional investors are increasingly doing so even

with money belonging to retired investors who need both cash flow and stability."

Of course, none of this discussion means that sharemarkets cannot continue to rise for months or even years. However, it does suggest that those looking primarily at US short-term interest rates as the key indicator of potential future trouble in sharemarkets and other asset markets should consider broadening their scope of vision to a range of other indicators and also to treat financial history more cautiously than in past cycles.

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