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## MARKETS & INVESTING

# Ignore the Cassandra chorus, rates won't skyrocket

## Market uncertainties more likely to lead to decline in rates than a spike up



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INSIGHT

When markets suddenly change their short-term trends or direction, prognostication abounds to explain the most recent gyrations. Often, those who missed the move leading up to the sudden change by sticking to an earlier erroneous call will suddenly issue statements to vindicate the veracity of their earlier predictions. Others, looking to justify the conventional wisdom, will seize an opportunity as proof that the masses were right and the conventional wisdom, whether empirically true or not, still holds.

Such has been the events of recent days.

With the sudden rise of rates around the world, the pundits present the recent sell-off as proof that long rates are bound to skyrocket as a result of any number of factors including reduction of the Federal Reserve balance sheet, tapering of quantitative easing by foreign central banks, lurking inflation and growth, fiscal stimulus from Washington DC, and so on.

In moments like these, I think

it is wise to step back and grasp the big picture. The Fed is on course to continue raising rates. If it does not, it is only due to weakening growth or inflation. Either way, case history tells us that the yield curve will continue to flatten.

As for skyrocketing long rates, that seems unlikely during the current economic cycle. Virtually every business cycle ends with an inverted yield curve. If the yield on the 10-year Treasury note were to rise to 3 per cent, that would imply an overnight rate at 3 per cent or higher. Using a number of metrics, an overnight rate of 3 per cent would be so restrictive as to induce a recession.

Even the Fed, which has notoriously forecast rates higher than the market delivers, sees the longer term "terminal" rate (the apex of the policy interest rate during the business cycle) at 3 per cent. Given the structural debt load on corporate balance sheets, a 3 per cent short-term rate would ultimately prove unsustainable. With a cap on short-term rates around 3 per cent, the likelihood that longterm rates could be sustained above 3 per cent for any period of time is low.

Then again, there is a fairly good argument that the terminal short-term rate may be lower than 3 per cent. Deflationary headwinds continue to restrain

price increases. With declining energy and commodity prices, supply gluts in automobiles, competitive restraints on retail merchandise such as groceries and apparel, and a growing inventory of new apartments weighing on owner-equivalent rents, these headwinds are unlikely to dissipate anytime soon. Since inflation is tamed when real rates rise enough to choke off economic expansion, the lower the level of inflation, the lower is the nominal rate necessary to restrain it.

If that's the case, then the terminal rate is likely to be closer to 2 per cent.

Only time will tell but that scenario argues for less policy tightening by the Fed as further rate increases are likely to slow the economy and inflation more than expected.

There is also the issue of valuation. Many routinely argue that bonds and stocks are overvalued yet the empirical evidence is sketchy.

As for interest rates, the last era of financial repression between the 1930s and 1950s resulted in long-term rates remaining below 3 per cent for more than 20 years. The argument that 10-year yields need to be close to nominal GDP growth rates is equally unsound as, aside from the era of opportunistic disinflation from 1980 into early in the new

millennium, 10-year yields on balance were below nominal growth rates for most of the past century.

Finally, the downtrend in long-term rates that began in the early 1980s is firmly intact. To break that 35-year trend, the 10-year note would need to yield more than 3 per cent for some period of time. Even if we did break that downtrend, history shows that rates will tend to move in a sideways consolidation for a number of years, often retesting the lows more than once.

The simple truth is that, while rates may trend higher in the near term, the risk is that we have not reached the point where the macro economy can sustain persistently higher rates. If anything, political, military and market uncertainties would more likely lead to another sudden decline in rates rather than a massive spike upward.

Investors would be wise to ignore the growing chorus of Cassandra cries and look through the noise to the fundamentals. There are many things to be concerned about in the world but skyrocketing rates is not likely among them.

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