All eyes on Fed to get the rates ball moving

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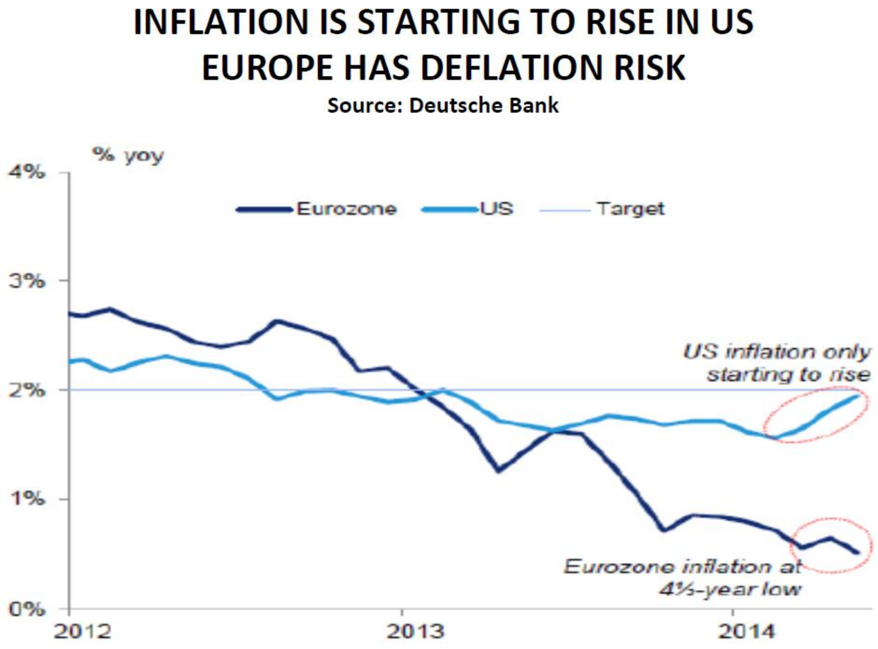

SINCE the global financial crisis hit in late 2008 interest rates have been unusually low. Many rates have declined again recently. Understandably, investors hunting for yield ask why are interest rates are so low, and when are they likely to start rising again.

Low interest rates are not the only standout feature in investment markets.

Interest spreads — including the gaps between yields on government bonds and those on corporate bonds — have narrowed a lot. Sharemarkets and property are strong. And volatility has just about disappeared in each of bond, share and foreign exchange markets. Any explanation of why interest rates are so low has also to bring out what's been happening to interest rate spreads, shares, property and volatility.

The dominant cause of these several outcomes is, in my view, the ultra-easy settings in the monetary policies of the major central banks. And the impact on investor behaviour has been magnified by market expectations that the US will leave its near-zero cash rate unchanged until the second half of next year.

That's mainly because, as the chart shows, US inflation has risen only a little; also, the Fed is of the view that there's more slack in the US economy than is suggested by the measured unemployment rate of 6.1 per cent.

There's also the thought that Europe's low inflation could morph into deflation — and further boost European investors' appetite for bonds.

The consensus forecast for global growth this year has been progressively cut back in recent months and now stands at a modest 3 per cent — low enough to encourage bond investors to stay put but not so low as would cause share investors to rush to the exits.

The global excess of saving and huge differences in saving rates country by country are causing big flows of funds across national boundaries — helping to keep interest rates low in countries such as the US and Australia. So far, China has maintained its tight regulation on private capital outflow — though these controls have increasingly been described as “porous”, even while liberalising capital inflow.

As a result, China’s overall balance of payments has tripped into larger surplus and official holdings of international reserves have risen to $US4 trillion ($4.3 trillion).

China has been buying US bonds, especially on days when stronger economic numbers are released in the US and US bond yields have drifted up. If, as seems likely, controls on private capital outflow are relaxed, China’s holdings of international reserves and its demand for US bonds seem likely to decline.

Australia’s AAA rating has attracted offshore investors, particularly central banks and sovereign funds, to our government bonds.

We’ve also seen strong demand for Australian interest-bearing investments from Japan and other countries — helping to bring down interest rates here and to keep the Australian dollar relatively strong.

The US has held its cash rate at close to zero for almost six years — and that’s despite the economic recovery, US banks having re-capitalised, share prices (as measured by the S&P 500 index) almost tripling since March 2009, and average house prices rising by 10 per cent in the past year.

Ten-year US bonds recently traded yields of 2.5 per cent — only half a percentage point more than inflation.

In my view, the most likely trigger event to cause the general level of interest rates in the US and here to be moving up again will be expectations forming that, with the US economy stronger and inflation picking up, the cash rate in the US will be raised earlier than either the Fed’s forward guidance has been suggesting or investors generally have been anticipating.

Such a re-assessment could well lead to investors taking a sustained negative attitude towards bonds, particularly long-dated ones, and a more cautious view towards shares.

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