End is nigh for decades of falling interest rates

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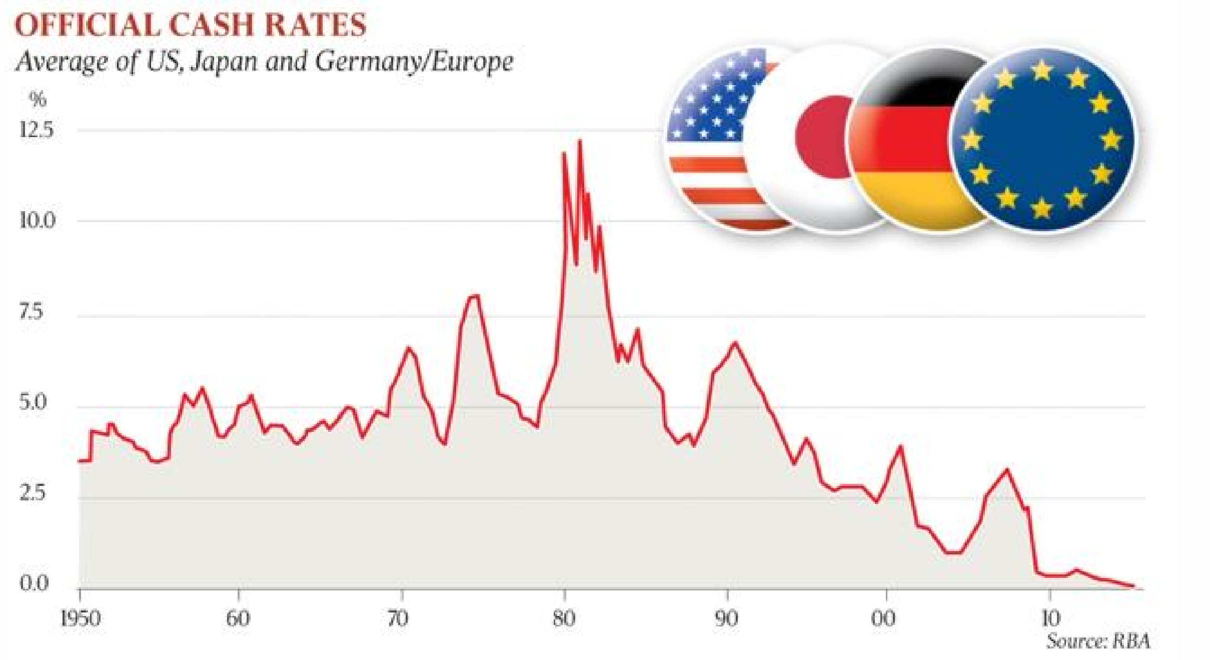

Interest rates *Source:* TheAustralian

Interest rates have been trending down in Australia since 1990 and even longer — since the early 1980s — in other rich countries. Since the financial crisis, cuts in cash rates, falling inflation and, globally — the desire to save exceeding the desire to invest — have combined to reduce interest rates to record lows.

As a result, market prices of a wide range of assets have increased; borrowers have benefited; but a lot of investors, including many self-funded retirees, have seriously depleted incomes.

In my view, we're about at the end of the multi-decade decline in interest rates, in Australia and globally; but the normalisation of rates will be a drawn out, and at times bumpy, experience.

The chart (below) shows the average cash rate across the three major economies since 1945 — the US, the euro area (Germany prior to 1997) and Japan. There's been a long-dated cycle (those who've studied economics might call it a Kondratiev cycle) with interest rates rising from the late 1940s to the early 80s and falling since then, overlapped by a short-term cycle averaging about eight years in duration.

In my view, the US cash rate is likely to be raised before the end of the year but cash rates in Europe, Japan and Australia — where there's more economic slack than in the US — are likely be left unchanged for much longer.

The US Fed is trying to manage market expectations to prepare for its first move in normalising the cash rate. But with little success: the dominant expectation in US financial markets is still for no change in the cash rate until well into 2016.

Janet Yellen, the chairwoman of the Fed, stated recently that if the economy continues to improve, as she expects, she thinks it will be appropriate at some point this year to take the initial step to raise the cash rate — provided the labour market continues to strengthen. She's reasonably confident inflation will move back to 2 per cent over the medium-term.

Yellen went further than before in acknowledging the "substantial lags in the effects of monetary policy" and that "delaying action to tighten monetary policy until employment and inflation are already back to our objectives would risk overheating the economy."

Following the initial rise in its cash rate, whenever it comes, the Fed's preference will clearly be for "gradual" and "cautious" increases in the cash rate.

But whether the Fed can deliver such a gentle trajectory for the US cash rate will likely depend a lot on how quickly US inflation rebounds. Prospects are that, as US short-dated rates rise relative to those in other countries, the US dollar will likely move higher.

Around the world, long-dated bond yields have risen in recent weeks — from earlier, very low levels. The lead came, somewhat unexpectedly, from Europe. Investors haven't suddenly formed expectations of resurging growth and inflation — more simply, earlier fears of recession and deflation in Europe have given way to the less pessimistic outlook of slight growth and mild inflation.

As I've mentioned, my guess is we've seen the low point in the global interest rate cycle but the return to "normal" interest rates will be a drawn out, and occasionally bumpy, experience.

Philip Lowe, the deputy governor of the Reserve Bank put it well in his recent speech to an audience of chief financial officers. "We should all hope that this period of extraordinarily low interest rates does not persist for too much longer: that, over time, confidence lifts and once again businesses compete strongly for the world's available pool of savings to fund investment in productive assets."

He then suggested: "Once this happens, higher returns will again be offered to savers. Lowe's own view is that there is a reasonable prospect that, in time, this will indeed take place and that some normalisation of interest rates will occur. But it also seems plausible that the average return on savings, at least for a protracted period, will be lower than it had been previously."

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