INVESTING IN A WORLD WITHOUT YIELD

QUARTER 3, 2020

In the aftermath of the 2008 Global Financial Crisis (GFC), interest rates in the developed world fell to unthinkably low levels. Central banks in Europe and Japan eventually employed negative interest rates to stimulate economic growth and prevent deflation.

While zero or negative inflation might sound like a good thing, the general view among economists is that it saps the economy of dynamism and the ability to adjust to outside forces. Low and stable inflation is better.

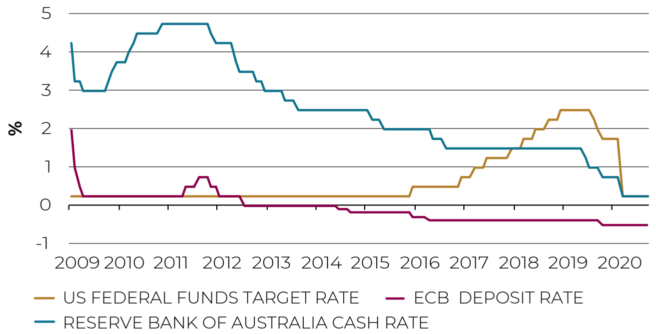
Among the major central banks, only the US Federal Reserve had enough faith in the post-GFC recovery to start hiking interest rates – tentatively – in 2015. By early last year, it was forced to reverse course. Even the relatively strong US economy couldn't handle moderately higher interest rates.

Then Covid-19 hit, with its fresh deflationary impulse across the world.

THE RACE TO ZERO

Across the developed world, interest rates have now been cut to basically zero. Negative interest rates are being discussed in unlikely places like New Zealand, while bond buying has been deployed in Australia and Canada for the first time. The Fed, ECB and Bank of Japan have been particularly aggressive in buying bonds as a form of stimulus (a policy known as quantitative easing).

Chart 1: Central bank policy interest rates, %



Source: Refinitiv Datastream

The unprecedented steps taken by central banks is one of the main reasons equity markets recovered so quickly after the March sell-off. However, while central banks can stabilise the financial system and ensure that credit continues to flow freely, there is a limit to what they can do.

They cannot get reluctant travellers onto airplanes, or fill theatres or sports stadiums, or put laid-off waiters back to work. And they certainly are not in the business of developing vaccines.

Nonetheless, they will play an important role in supporting the economic recovery. It is therefore notable how thinking has changed inside central banks.

Of particular importance, the US Fed recently announced the outcome of a review of its policy framework it commenced last year. It has adopted a flexible average inflation targeting approach. This means that instead of aiming to keep inflation at 2%, it wants inflation to average 2% over time. Since inflation was below 2% for most of the past decade, a period of inflation rising above 2% will be needed to lift the average. In other words, the Fed will tolerate, indeed welcome, inflation above 2%. This all but guarantees negative real interest rates for investors.

The Fed will also not hike interest rates at the first sign of the jobs market heating up. It came to the conclusion that low unemployment does not result in accelerating inflation. For now, though, that would be a nice problem to have.

Across the Atlantic, the European Central Bank also launched a review of its policy framework. It has been even less successful in meeting its inflation target in the past decade. Its more immediate worry is that a relatively strong euro will put even further downward pressure on inflation. Its policy interest rate remains at -0.5%, while the €1.35 trillion bond-buying programme will continue "as long as necessary to reinforce the accommodative impact of policy rates."

OLDMUTUAL

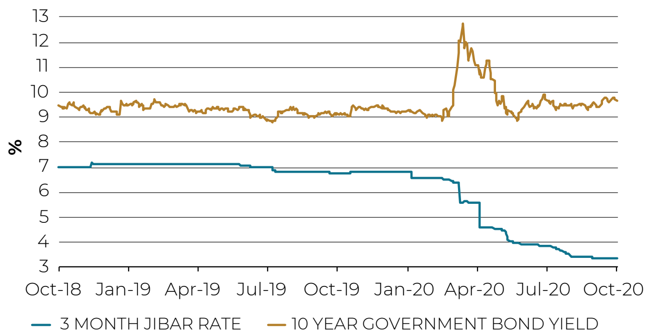
Another difficulty facing the ECB is that some Eurozone countries, notably Germany, have emerged from the coronavirus pandemic relatively unscathed, while the likes of Spain and Italy suffered serious damage.

WORRIES OVER DEBT, NOT INFLATION

Locally, the Reserve Bank cut its policy rate to the lowest levels since the 1960s. However, unlike in developed countries, long-term bond yields have not responded to lower short-term interest rates.

The longer-term bonds are pricing in a very pessimistic scenario over government debt levels.

Chart 2: Short- and long-term South African interest rates, %



Source: Refinitiv Datastream

Government debt, and not inflation, is therefore the main challenge for the Reserve Bank at this stage. Inflation is under control and expected to average 3.3% in 2020. Rather, the Bank worries about the prospect of the rand blowing out should investors panic over rising government debt levels. The government has promised to stabilise debt levels over the next few years, but this will require much more discipline on the spending side, and the market is sceptical.

Meanwhile, economic growth is constrained by structural bottlenecks such as electricity supply. Cutting interest rates cannot generate more electricity, nor can they attract more foreign tourists to South Africa.

The September Monetary Policy Committee meeting resulted in an unchanged repo rate of 3.5%. Though the decision was not unanimous with two of the five members voting for another cut, it seemingly signals the end of the cutting cycle.

WHAT DOES ALL THIS MEAN FOR INVESTORS?

There are four broad take-outs for investors. We are clearly in a lower-for-longer global interest rate environment. This should support risk assets like equities. Central banks cannot and will not remove all volatility, so corrections can still occur, but lower interest rates create an attractive backdrop for equities.

Importantly though, global interest rates cannot fall much further from here, and therefore future equity returns will depend on earnings growth rebounding.

Secondly, the search for yield is also likely to extend to emerging market bonds and equities, a trend that should benefit South Africa even though we are by no means the favourite within the emerging market universe in either asset class. A rising tide lifts even the most battered of dinghies.

Thirdly, the Reserve Bank has received a major gift from the Fed's lower-for-longer interest rate stance. Between 2013 and late 2018, the Reserve Bank had to continuously look over its shoulder at what the Fed was doing or planning on doing. The Reserve Bank and other emerging market central banks now have room for a few years to set policy with a greater eye on domestic considerations.

Finally, a low interest rate environment has implications for South Africans too, particularly conservative investors. Unlike in previous years, money market returns are unlikely to beat inflation after tax. Investors will have to weigh up the stability of money markets against the prospect of declining purchasing power over time.

IZAK ODENDAAL
INVESTMENT SPECIALIST
OLD MUTUAL MULTI-MANAGERS