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How to protect your portfolio when low interest rates normalise

Here's the problem for investors - interest rate "duration" risk is back. **James Davies**

by **Christopher Joye**

Contrary to popular reading, the savage jump in our government bond yields and, to a lesser extent, the exchange rate, following the Reserve Bank of Australia's board meeting this week had relatively little to do with the fact Glenn Stevens dared to drop his "easing" bias.

Tuesday's otherwise unexpected (at least by most) jump in long-term rates was determined by much larger foreign forces. A little appreciated fact is that Australia's three- and 10-year government bond yields, which are the market's best guess as to where the cash rate will be on average over those periods, are more than 90 per cent correlated with equivalent US rates. This is true in other economies too.

So why were US yields rising? It turns out that a heterodox case I have repeatedly posited here – whereby the popular and financially convenient "low rates for long" meme is junked by budding US wage pressures spooking bond bandits – has finally arrived. The issue overlooked by most investors is that the 5.5 per cent jobless rate in the US is not far above the cyclical troughs attained before the 2001 "tech wreck" and the 2008 global financial crisis. In both episodes equities were crushed by 50 per cent or more. More significantly, the never-before-seen zero interest rate policy

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maintained by the Federal Reserve more than four years after gross domestic product growth in the US returned to positive territory has forced the jobless rate through a crucial threshold below which wage pressures tend to materialise.

In 2014 the Fed's current chair, Janet Yellen, revealed her own estimate of this so-called "non-accelerating inflation rate of unemployment" (NAIRU). "The unemployment rate consistent with maximum sustainable employment is now between 5.2 per cent and 5.6 per cent," she said.

Based on Yellen's analysis, we are close to technical full employment, which is awkwardly juxtaposed against the cheapest money in human history.

NASCENT REAL WAGE GROWTH

The predictable result that few expected is nascent real wage growth. Between early 2009 and mid 2014 US wages failed to keep pace with inflation (real incomes were shrinking). But this changed last year as the US jobless rate converged towards the NAIRU. Over the six months to December 2014 private-sector wage costs expanded at more than 1 per cent above the 1.8 per cent US inflation rate. Combined with evidence of healthy consumer price pressures in Europe this week, bond traders decided they had been sold a dummy with the spectre-like "deflation" bogeyman that has failed to crystallise.

With the exception of the venerable Perth-based global equities manager and polymath Willy Packer, pretty much every sophisticated investor I've spoken to over the past 12 months has eagerly embraced the "low rates for long" paradigm. It makes for a conveniently benign world view: record low rates benefit almost every asset class and have ignited stunning paper profits across equities, bonds and property.

Yet it is as intellectually lazy as the fallacious 1990s and 2000s fads that sparked the tech boom and leveraged finance bubbles. These included Ben Bernanke's "Great Moderation", the title of his poorly timed 2004 speech that led to folks thinking the business cycle was dead. It was preceded by the 1990s "productivity miracle", which was deployed to rationalise crazy internet stock prices. And it was superseded in the 2000s by the myth propagated by lenders and banking bosses that house prices always appreciate. This supported the message that residential property borrowers rarely default on their loans. While these era-defining ideas were eventually debunked, they continue to influence behaviour today.

The belief that house prices are immune to steep falls and borrowers always service their debts helped the big banks convince regulators to allow them to slash the "at-risk" share of a home loan they have to hold capital against from 50 per cent before 2008 to just 18 per cent today. This enabled the majors to increase the leverage they use when funding residential mortgages to more than 70 times, which is the rocket fuel that propelled their 18 per cent plus returns on equity. It never ceases to amaze me how few ostensibly well-credentialed and important investment professionals understand the banks they entrust their savings to.

The contemporary low-rates-for-long maxim is burnished by the belief that highly indebted economies need to deleverage, which will sap growth and act as a disinflationary force. I've countered that myopic politicians will choose the more palatable path of eroding the real cost of their interest repayments through the

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debtor's favourite friend, inflation. Cultivating a higher cost of living is, after all, the publicly stated aspiration of most central banks.

This curious goal is explained by the desperate desire to avoid deleveraging, the risk of supposedly deadly deflation, and/or a cathartic downturn that would belatedly allow bad businesses (eg, 25 times leveraged banks) to fail so that they can be supplanted by more productive concerns that better harness our scarce capital and labour resources.

Oh, that's right: the banks are too big to fail. And if you ever doubted the government's commitment to ensuring they are never subject to the disciplines of the market mechanism, politicians have permanently guaranteed their funding (ie deposits) and, uniquely in Australia, furnished them with unlimited liquidity via the RBA. Of course running rings around the second-rate pollies is much easier when you have the last RBA governor, Ian Macfarlane, and long-time Treasury secretary, Ken Henry, serving on your board.

'DURATION' RISK IS BACK

So here's the problem for investors. Interest rate "duration" risk is back, as I previously warned. The three-year Aussie government bond yield and the even more important 10-year benchmark have leapt from 1.64 per cent and 2.28 per cent, respectively, in mid-April to peaks of 2.15 per cent and 3.05 per cent this week.

Recall that these sovereign yields are the "risk-free rates" that are a fundamental part of the total "discount rate" that is used by professional investors to value a company or property's future cash flows in current dollar terms. If you jack up the discount rate, the price of the asset mechanically declines. And so it has proved with equities as long-term rates have soared. This eviscerates the silly claim that long-dated "fixed-rate" bonds are a powerful equities hedge. Sure sovereign bond prices appreciated during the GFC when equities slumped. But there are many more historical episodes when bonds have been smashed in concert with shares and property as rates climbed in response to inflation shocks.

The one thing all investors should be thinking about right now is where the long-term risk-free rate, or 10-year government bond yield, will likely land. Since the early 1990s the 10-year benchmark has averaged almost 6 per cent. This fits neatly with my rule of thumb that the economy's equilibrium long-term interest rate should approximate its nominal growth rate. Australia's nominal growth over the same period has also been around 6 per cent. This is made up of real GDP growth of circa 3.5 per cent and core inflation of 2.5 per cent. Take a more conservative position and assume that future real GDP growth will be much weaker at, say, 2.5 per cent. Also optimistically suppose there is no inflation breakout, with core prices inflating at only 2.5 per cent. That gives you total nominal growth of 5 per cent, which is arguably where our 10-year bond yield should be today.

So why are yields only slightly above all-time lows? The answer is found in the more than $10 trillion central banks have spent buying bonds to bid up their prices and artificially lower risk-free rates (boosting all asset values in the process). Accordingly, the bond (and equity) prices we observe today are likely to be far removed from their true market-clearing levels. What will protect your portfolio when long rates normalise back to 5 per cent and the "low rates for long" narrative fills another chapter in the history of failed mental crutches?

The obvious solutions are genuinely hedged equities (eg, market neutral funds), cash, floating-rate notes and, possibly, gold.