How Dependent Is The Economy On Low Interest Rates?

Corporate balance sheets have been significantly repaired since the crisis of 2008. On the other hand, sovereign balance sheets became and remain in poor condition. Most countries have addressed this problem by instituting programs of debt monetization with, as an associated bonus feature, artificially low interest rates across the relevant term structure.

This lowers costs of debt capital for private businesses, if they are able to access credit, and has provided businesses the opportunity to raise debt and of refinance existing debt at lower rates improving margins thus simultaneously improving liquidity, profitability and this solvency. Equity valuations are also enhanced as discount rates are reduced and comparisons of earnings yields to alternative sources of return such as treasury or corporate bond yields are also improved.

While there is real improvement in corporate solvency and profitability, much depends on interest rates. The questions are, can central banks keep rates low, for how long can they keep rates low, and, how robust are balance sheets and profitability to rising interest rates.

How long will central banks maintain low interest rates? For as long as it takes, seems to be the universal answer, which is reassuring. At least mostly. Interest rates represent a hurdle rate when making an investment. Artificially low interest rates can encourage excessive risk taking or simply ill advised investment leading to misallocation of resources. Also, in a market economy, it might be hoped that the price of capital, arguably the most important price in the exhaustive set of prices in the economy, should be determined by the market and not a central planner unilaterally declaring a price. Academic issues are quickly subordinated to more practical concerns in times of crisis, and yet it seems that the practice has predated and survived the crisis. Let us assume, therefore, that low interest rates are good, thereby transforming a thesis into an assumption.

How are central banks achieving low interest rates and why might they fail? Central banks are able to set short rates by declaring their own short term rates at which they will lend or borrow. The banking system transmits this through their deposits at the central bank by pricing loans as a spread over this base. At longer maturities, the central bank may either do the same and provide credit at longer maturities or it can buy government bonds, simultaneously setting a rate and funding the state. There are some limitations to this strategy. Inflation may accelerate. While a little inflation is a good thing, excessive inflation is not, and runaway inflation tends to be the product of a loss of confidence rather than a continuous erosion of purchasing power. With a money base as inflated as most central banks have, one has to question how this money base will be shrunk when the economy recovers. Also, since the velocity of money multiplies the money base in the measurement of nominal output, a small pick up in the velocity of money could lead to a jump in inflation. Also, asset sales by a central bank which has crowded out the sovereign bond market could make for a very unstable term structure. Confidence can also affect the currency which could force a damaging defense involving higher interest rates.

How robust is the economy to higher interest rates? With interest rates at such low levels, interest expense is highly convex to interest rates. Household debt service is therefore quite sensitive to higher interest rates. Households appear to be aware of this as they increase their savings and reduce debt. The same can be said for corporates which have raised significant levels of fixed rate debt to lock in current interest rates. Corporates cash hoard will also probably mitigate some of the impact of higher rates.

PS:

It is a peculiar time for investing. Investors cannot see beyond low interest rates, reasoning perhaps that the implication of higher rates is simply too dire for governments or central banks to bear. Under a regime of low interest rates, now that the yield has been wrung out of bonds of almost all regions and issuers, equities shine as good value. Investors seem to even have forgotten the volatility of equity investing, seeking yield in the form of dividends. (One could say that dividends dampen the volatility of stocks but the other argument is that yields are far too low for an asset of infinite duration.)

As for hedge funds, the mass of them provide some equity correlation, some spread duration but for the most part generate a negative alpha. As one would expect in the opaque world of hedge funds, a small group continue to generate very attractive returns without taking excessive risk, certainly taking less risk than the garden variety long only mutual fund, unfazed by the macro vagaries of the market, engaging in arbitrage or relative value or trading in niche markets where they have an edge. Most investors will not have the access to these managers, or the resources or faculties to make sense of their activities, keeping them relatively compact compared to their long only brethren, keeping them hungry and nimble. As the growth of the size of the pie slows, it is increasingly important to engage managers most able to take a bigger slice of it on one’s behalf.