Living with Low Interest Rates

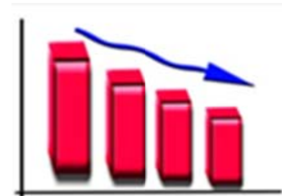
Are low interest rates here to stay?
What is wrong with the Western World?
Be prepared: actions you can take now.

When the economy is strong, everyone dreams of low interest rates, because this makes it less expensive to borrow money. And, when the economy starts to falter, Central Banks set low interest-rate targets in their efforts to spur their economies.

Lower rates encourage businesses and consumers to borrow and buy things. Loans put money into circulation and raise the money supply, which supports an economic recovery -- to a point. Low interest rates can also be a damper on the economy and to business.

Are low interest rates here to stay?

It looks like it; as an indication of where world interest rates might be heading, the ABC News of 27 August 2017 (1) reported that the German government has issued 824 million euros in bonds, which offered to give investors their money back, and nothing more, in 30 years' time.



HSBC's chief economist Paul Bloxham thinks that Australian interest rates are set to stay at record low levels; at least until 2025, if the bank's forecasts for the interest rate on the 10-year US government bond yield holds true.

When interest rates are too low, more people are willing to borrow money to make big purchases, such as cars and residences. When consumers pay less in interest, this gives them more money to spend, which can create a ripple effect of increased spending throughout the economy.

Home Owners

A low interest rate environment is great for homeowners because it will reduce their monthly mortgage payment. However, the Reserve Bank has delivered a warning on the consequences of interest rate cuts, even as it is slashing them to record lows. "We can be confident that lower interest rates will push up asset prices, and I think that later on we will have problems because of that," said RBA governor Philip Lowe(2)

People living off their savings

Low interest rates negatively affect people who live off the interest income from their savings, so they cut back their spending. When a large group of people, such as the baby boomer retirees, reduce their spending, overall economic activity slows.

When people can't earn attractive interest income on their money in savings accounts and certificates of deposit, they either use their money to pay down debt or invest in goods, services or assets like houses and stocks. This means banks lose deposits. Low interest rates also affect insurance companies that rely on a certain interest-based return on the money they receive in premiums to support their coverage liabilities, so your insurance premiums may rise. (3)

Borrowing Money Becomes Difficult

Banks generally have lots of money in their deposit accounts, attracted by high interest rates, so they are eager to lend. However, when interest rates are abnormally low, banks don't have a high deposit base and the income from loans doesn't encourage taking risks, so they only lend to borrowers with the highest credit ratings and substantial assets to support those loans. (2)

The Banking Royal Commission has effectively imposed restrictions on lending which has made life quite difficult for those people needing to raise temporary loan capital, such as developers. This policy has encouraged growth in the non-bank fixed interest market for shorter term loans. Used with care and awareness, this market can provide useful investment opportunities.

What is wrong with the Western World?

For one respected view, we refer to an article entitled: "Take note of the man who cried wolf" by Marcus Padley, in The Age of 4 September 2019(4).

Padley's article is based upon a recent video presentation by Donald Amstad. Mr Amsted is head of investments specialists, Asia, at Aberdeen Standard Investments, a global fund manager that has more than $1 trillion in assets under management in 80 countries.

Marcus Padley writes: "Mr Amstad does a great job of explaining what is wrong with the Western World. We suspect there is something wrong – the conundrum of negative bond yields and the recent increase in stock market volatility tells us that the markets have begun to pick up on it, too. Mr Amstad nails it – and it's not good news. He concisely pulls together all the threads and makes obvious all those things we know to be true.

The source of all evil, he tells us, has been money printing by the West, an event that "shocked" many Asian countries. The Asian crisis in the 1990s could have been solved by money printing but their governments refrained because the International Monetary Fund warned them their currencies would be destroyed by devaluation and their economies by hyperinflation.

Instead, they took their medicine, reset their balance sheets, went through the pain and emerged years later better for the process. Come the Global Financial Crisis in 2008, which Amstad notes was a Western financial crisis not a global financial crisis, the US and Europe took the easy route. They didn't take their medicine, they printed money and, a decade later, with all that new money swilling around, the consequences are clear to see – interest rates are low or negative and going lower.

The West is on the edge of a financial cliff – printing money at times of market stress cannot continue and central banks are out of ammunition. Mr Amstad says this "bond bubble" has put the Western World on the edge of a financial cliff – that habitually printing money at any sign of financial market stress cannot continue and that central banks are now almost out of ammunition.

After the final rate cuts and the recommencement of quantitative easing, the inevitable will happen, he says. The bond market will burst and, when it does, the money printing governments will lose the ability to endlessly fund themselves, as no-one will want to buy their bonds and the bonds already issued will become "unrollable."

On top of that – and more relevant to equity market investors – the money that had been finding its way from the printer, through the bond markets, into the investment banks and then into the stock market – the money that has put US$25 trillion dollars' worth of S&P 500 companies on a fantasy world multiple of 21 times earnings – will end. Equity markets will fall and so called risk-free assets will be revealed as being anything but.

We are at the end of the game: At a corporate level, the banks that rely on a rising yield curve, high interest rates and asset price inflation will see the opposite of that. They will not be able to find a margin to make money, let alone grow. Some will go out of business.

The West is verging on catastrophe, says Mr Amstad, and the markets are only just beginning to wake up. "We are at the end of the game" and the West "has to take its medicine," he says. When it does, you will need a markets blindfold because "it's going to be pretty scary."

There are many market commentators that talk down the markets. They serve a purpose because they balance out the rest of the financial market herd that has institutions that are commercially biased toward optimism. We need these canaries in the coal mine. However, the scary thing is Mr Amstad is not one of them. He works for one of the financial institutions.

The problem, as with all financial disaster scenarios, is timing. The questions for all of us are not only whether Mr Amstad is right, but possibly when? With the financial system set up to protect itself, this oblivious bull market could still perpetuate itself for a lot longer yet"

You can see Mr Amsted's presentation by following this link:
https://www.theage.com.au/money/investing/take-note-of-the-calibre-of-the-man-who-cried-wolf-20190903-p52nfg.html

Be prepared; take action now.

Low interest rates are a fact of life at present. And, as ever, we can't change the facts. We can't control events, but we can control our reaction to them.

Remember the Boy Scouts Motto, 'Be Prepared'. We put the question of how to live with low interest rates to Andrew Hewison, Managing Director of Hewison Private Wealth, and Chris Morcom, Director and Private Client Adviser. Andrew and Chris have kindly responded as follows:

The reality is that while some macro-economic trends are easier to predict than others, markets do not always react the way we think they might. The question is, how do you build a portfolio that is best placed to cope with market unpredictability?

1. At the outset build a diversified portfolio with defined percentages in each asset class. At a base level, the broad asset classes to consider are cash, fixed income, Australian shares, International shares and property. Further diversification within each category is also important. This will involve investing in assets such as property and shares.

Since the GFC Hewison Private Wealth has increased the resilience of client portfolios by considering domestic and global infrastructure, private equity and a broader mix of unlisted property exposure across commercial, agriculture, mixed use retail and hotels.

2. You need to be satisfied that the asset mix will achieve your long term goals and objectives regardless of market conditions. In our view, unless your specific needs change, your asset allocation should not change. We call this a 'strategic asset allocation'. Adjusting your asset allocation according to market predictions is fraught with danger and over time will not be successful.

3. Control and flexibility need to be a priority. Being able to take action at the appropriate time (buy or sell) is paramount. Where at all possible, we prefer our clients to own their investments directly and not through a third party manager. This enables you to be in control of what to do with your portfolio and when you do it.

4. Capital growth generally comes over the long term, and cash flow generated from your investments will underpin its performance in the short term. We prefer to design client portfolios so that overall, they are supported by strong cash-flow.

5. The current one-year term deposit rate is around 2% per annum, whereas the current annual inflation rate in Australia was 1.6% at the end of June. Retirees invested in term deposits want to keep their capital safe and to live off whatever income they can generate. However, when doing so, they may not be considering the continual rise in the cost of living.

When assessing your fixed income exposure in a low interest rate environment, consider two things:

a) Fixed income does not have to be limited to term deposits only paying less than 2%. There are other reliable options that can pay a great deal more, but unfortunately, specialist knowledge and experience is required to assess and access them, and

b) Fixed income can form a stable component of a portfolio that can be used effectively to rebalance the portfolio.

For those who experienced the Global Financial Crisis as retirees, the thought of having their hard-earned superannuation invested in such assets may be cause for alarm. However, since 2009 share markets and property markets around the world have recovered strongly from their lows and in the main have gone on even higher.

6. Rebalancing: We have saved the best for last. As growth asset classes fluctuate in value, opportunities will present themselves to sell (take profits) and to buy (undervalued opportunities). By keeping your asset allocation constant, you will over time become overweight and underweight in each asset class. At the appropriate time, overweight assets should be sold and underweight assets should be purchased.

In summary, while the current day economic landscape is uncertain, it is not unique. Market events run in cycles. Furthermore, there are events that can occur completely from left field. The unfortunate reality is that without a crystal ball, as investors we need to accept the good times with the bad.

Ultimately, remaining invested via a diversified portfolio of quality investments that you control and rebalancing when required is the most appropriate strategy for long term success (5).

References

(1) David Taylor, ABC News report, 27 August 2019)
(2) Herald Sun, 27 August 2109
(3) The Disadvantages of a Low Interest Rate, *by Victoria Duff smallbusiness.chron.com*
(4) Marcus Padley is the author of the daily stock market newsletter Marcus Today. This article was reproduced under licence from The Age.
(5) Per Andrew Hewison, 11/9/19, and Chris Morcom's blog "Combatting low interest rates in retirement"

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