

Where Interest Rates Are Going and Why



August 2017. There has been a lot of commentary lately that interest rates have finally, at long last, turned higher now that the Bank of Canada has increased rates, and that the US Federal Reserve seems intent on continuing to increase rates as well. The belief seems to be that we are now on a path towards “normal” interest rates. I will explain why I believe this is happening, why I think this is temporary, and why the long-term trend in interest rates is still towards lower, and ultimately, negative interest rates.

In normal times, prior to the global financial crisis (GFC), interest rates usually moved up or down in response to inflation (or the expectation thereof) and/or labour market conditions (i.e., unemployment). Central banks increased rates when they thought inflation was going up, the economy was too hot, and employment conditions were too tight and decreased rates when those conditions were the opposite. Historically, Central banks have not raised rates to

cool asset bubbles, but they have tended to decrease rates when markets have plunged. This is why the market talks about the “Greenspan Put” or the “Bernanke Put”; the assumption being that whenever the market faltered, the Federal Reserve would ride to the rescue and cut interest rates, and bail out the market and the banks that took too much risk and got hurt. This is not what is happening now. The messaging has changed if you listen carefully.

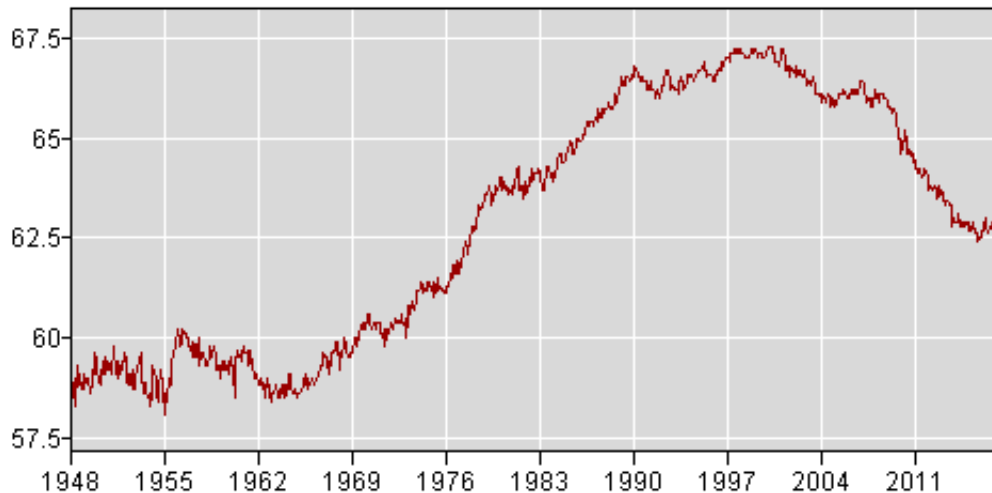
The path of interest rates, in the short-term, is clearly higher because of three reasons:

- 1) Central banks are now clearly concerned about asset bubbles and seem to be messaging that they will hike rates until the stock market comes to its’ senses. This is a change from previous behaviour and it is important to pay attention. Markets have continued to go up in the face of these increases on the false assumption that central banks are increasing rates because the economies are healthy and finally ready to absorb the impact of higher rates.
- 2) The central banks messaging since the GFC has been that rates would normalize soon, maybe within the next six months or so. Normalization for years was “just months away” and they repeated this message over and over. I do not believe for a moment that they actually believed what they were saying was true. They had to give that message (i.e., lie), or risk collapsing the economy. Imagine the message being that rates are never going to go up because the economy is broken and the unemployment situation will only get worse due to automation and “softwarization”, which will render employees obsolete resulting in an unstoppable force of deflationary pressure. The markets could collapse, and so could the economy as confidence collapsed. The market had figured out that rates are structurally low, and that the central banks were lying all around. Central bank messaging lost credibility. Raising rates now, is in part, an attempt by the central banks to restore their credibility (i.e., “see... I told you we would raise rates”).

- 3) Central banks know that we are in year eight of a five-year business cycle. The US economic expansion is now the third longest in history and no expansion lasts forever. Given how low rates are now, they know that they have little ammunition to rescue the economy and the market when, not if, the next recession comes. Thus, in raising rates now, they hope that they will have some room to cut them when the next recession ultimately hits.

The traditional reasons why central banks increase interest rates do not exist today. The increase in rates is not because the economies are booming. They are expanding, albeit slowly, and certainly not heated enough to raise rates, although an argument can be made that they are strong enough to remove some policy accommodation. It is not because inflation is racing higher. It is still below target. It is also not because unemployment is low and that wage pressures are on the horizon. While the central banks point to the official statistics on unemployment being very low, these statistics are bogus. They do not include millions upon millions of people, who have given up looking for work, that have “dropped out” of the labour force and thus are not counted as unemployed. Currently only 62.8% of working age adults in the US are “in” the labour force.

Figure 1: US Labour Force Participation Rate (Source: US Dept. of Labor)



As such, it is my contention that because of the above three reasons, central banks will continue to raise rates until the stock markets move lower.

In Canada’s case, the concern is about over-indebted consumers and a boom in real estate that the Bank of Canada want to slow down. They know that there is too much leverage in the system that poses a significant economic risk if they do not convince consumers, and stock market and housing investors to take less risk. Further macroprudential controls are likely, which should help cool the market as well.

Ontario’s introduction of a speculator tax and other measures has helped cool the market, if only for psychological reasons. Interest rates going up will not significantly affect affordability, but it could act as a warning to investors to be careful about leverage, and thus reduce speculation. Further, there seems to be discussion about further “stress tests” of borrowers to ensure that they can handle higher rates. Whether those higher rates come or not, the net effect is to reduce housing purchasing power and also to significantly increase down payments because borrowers won’t qualify for the sizes of mortgages that they used to be able to. In effect, this will work like an increase in the downpayment requirements, reducing overall leverage, and the number of people that can buy, without the political fall out of directly increasing downpayment requirements to a generation used to the idea that they have a right to receive

a mortgage with little or nothing down, backstopped by the taxpayers. They will either have to buy a smaller, less expensive place, put down more money, or they will have to rent (more on that in the Centurion Update).

These rate increases, once they have achieved the goal of cooling down asset markets, will likely turn lower as the economy rolls over, which cannot be far away given how long the current expansion has been. However, I do not think the central banks will move to save the stock markets, preferring to let some of the excess risk taking get “washed out” in the market, putting into question the assumed central bank put.

The next contraction, when, not if, it comes, will require an even more extraordinary response from central banks than last time as they have few tools left given how low rates will be when the next recession begins and how large their balance sheets had to balloon to even get the modest growth and inflation we have now.

My core economic thesis remains intact:

- 1) Globally, we may have reached “Peak Jobs”. This means that the total number of employed persons is the highest that it ever will be. This represents the greatest risk to the rise out of poverty of billions, as billions before them have been integrated into the global economy as part of global supply chains and seen progress as a result. This is because robots and software continue to make remarkable and rapid advances that threaten to replace many of the jobs that currently exist (e.g., self-driving cars and trucks, automated delivery, fully automated restaurants, manufacturing facilities, chat bots, AI software to do clerical work, automated bricklayers, 3D printing, etc.). More people wanting jobs with less employment opportunities means wages cannot go up. As machines become ever more efficient, faster, and cheaper, it will not make sense to pay most low to mid-earning employees anything. (Forget the push to a \$15 minimum wage, if a robot can work 24/7/365 for an all-in cost of \$1 without benefits, sick days, vacations, or complaints and delivers a higher quality product, etc.). This is a global deflationary force with no end in sight.
- 2) In the short run, robotization and “softwarization” would seem beneficial for stock markets. It is a means to higher profits in the short-term. In the long run though, people without jobs do not spend much, which will drag significantly on economic growth. Moreover, robotization and “softwarization” are ultimately destructive to corporate profits for large swaths of the economy. Most will lose and there will be a few mega winners (Amazon, Google types etc.). Think about what Amazon is doing to retailers, what AirBnB is doing to hotels, and what Uber is doing to taxi drivers.

Right now, to produce a product requires significant capital, human resources and intellectual property. Let us, for example, think about making cars. What happens when 3D printing advances to the next stage and the next car entrepreneur can dream up his design and can buy the robots, which, when fed the plans, can build the car from scratch in the entrepreneur’s own small plant or in an outsourced advanced 3D printing plant? There are so many barriers to entry for starting a business today that may go away when the intellectual know-how is no longer in entrepreneurs’ heads and organizations but resides in software supplied by the likes of Apple, Microsoft, or IBM. If almost anyone with an idea, can start a business, or copy a business and compete, competition will become even more intense, which will be bad for profit margins and is ultimately deflationary.

- 3) Global governments are addicted to debt. They are so dramatically dependant on debt markets to fund excessive social spending that they cannot afford rates to go up without collapsing their economies. In Canada, the federal government is running a large deficit mostly on increased social spending, not “investments”. As such, when the next downturn comes, they will not have the fiscal

room to spend into the economy (i.e., fiscal policy). The only choice will be to lower interest rates from their already very low base. With gaping deficits, increasing social payments due to increasing unemployment, and insufficient growth to ever pay down debt, negative rates will effectively be a tax on savers to fund these deficits and keep the economies and people afloat.

- 4) Low interest rates drag down inflation. Traditional economics has always stated that lower interest rates stimulate the economy and thus, in time, triggers inflation. In this cycle, we are seeing inflation, but only in asset prices, not in other prices. So why not? In traditional recessions, inefficient companies get wiped out, the high interest rates take out the overleveraged or marginal businesses such that overcapacity is reduced (e.g., factories go out of business and no longer sell their products). In the current environment, ultra-low rates have allowed excess capacity to build up, by keeping companies that should have been wiped out in the last recession (or the next one for that matter) operating, keeping the world flooded with capacity which is deflationary. Negative rates, when they come, will reinforce the deflationary cycle.
- 5) Low interest rates increase savings rates, which drags down spending when the economy is not accelerating. Traditional economics suggests otherwise as the view is that with lower rates, consumers have more incentive to take on debt and spend, and businesses will borrow to invest, thereby stimulating the economy. However, when people see long-term economic stagnation ahead, and that interest rates would not rise substantially or normalize, they know that they need to significantly increase savings to have any chance of a decent retirement. It forces them to take silly risks like speculating in the stock market. Look at what has happened in Japan where with a rapidly aging society, and zero interest rates which have lasted decades, they have to save everything they can to have any chance to fund their increasing lifespans. Zero rates have not managed to grow the economy materially or stop deflation.
- 6) The developed world is aging. This means more savings for retirement, less consumption, slower growth, and less inflationary pressure as a result. Some would argue that the developing world is still very young with booming populations, which will work to boost global demand. These emerging economies have traditionally benefitted from globalization and outsourced manufacturing. While the first stage was largely jobs in sweat shops (think China), they eventually progressed to high-tech manufacturing (think Taiwan and Korea). Robots and software may now allow production to become localized near end consumers, which means little, if any, economic opportunity to ultimately create demand to feed into the global economy, meaning they become irrelevant to the ability to balance the aging developed world. While Merkel has attempted to import some young blood into an aging Germany, this did not come without cost, and the appetite to continue that social experiment is likely at an end, such that immigration is unlikely to reinvigorate the developed markets.

To sum it all up, low inflation or disinflation lies ahead, increasing structural unemployment with slow growth and widening wealth inequality. The implication for interest rates is up in the short-term until the central banks manage to cool markets of their speculative fever and then to new lows in rates, and ultimately, negative rates to respond to the next recession when it comes. Fortunately, I believe that our portfolios are positioned well to benefit from this scenario.

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