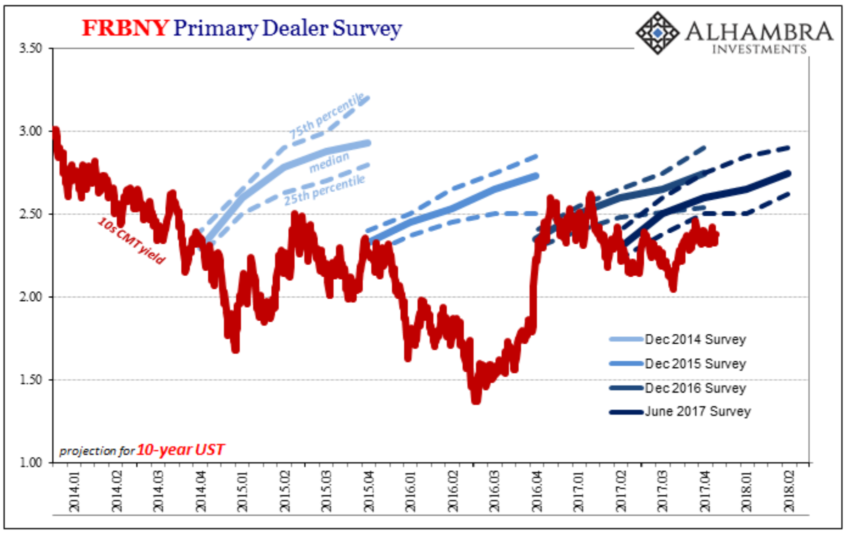
Will 2018 be the year of higher interest rates?

You have to admire the consistency and conviction of economists – even if accuracy sometimes leaves something to be desired. Economists have consistently forecast for the past four years that the US Federal Reserve would soon increase interest rates and that this would lead to higher long-term bond rates in the US (and by extension, given the importance of US bond markets, for the rest of the world). Clearly with 10-year bond rates still at much the same level as 2014 – these past projections haven't been right – but will 2018 be the year that long-term bond rates move decisively higher?

This is a critical issue for all investors – as low long-term interest rates have been a key explanation for the elevated valuation multiples of public and private assets (that is, TINA, or There is No Alternative as an explanation of asset pricing).

Chart 1: Wall Street Economist Surveys of Interest rates

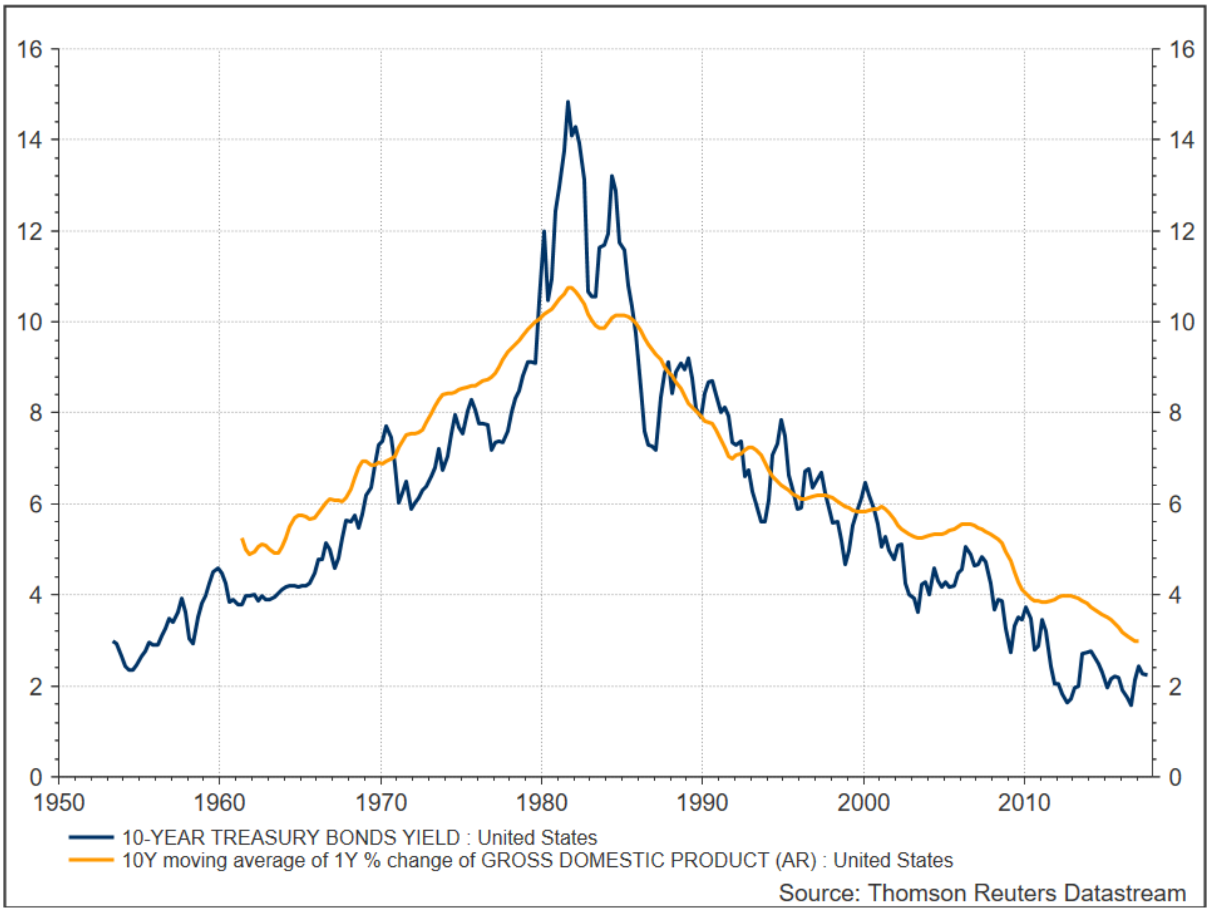
"Even a stopped clock is right twice a day"



Economists expectations of higher bond rates are premised on:

1. Traditional relationships between long-term nominal GDP growth and long- bond rates. If US real GDP growth is expected to be 2-3% and inflation 1-2%, this would imply a 10 year bond rate of 4-5% - not 2-3%.

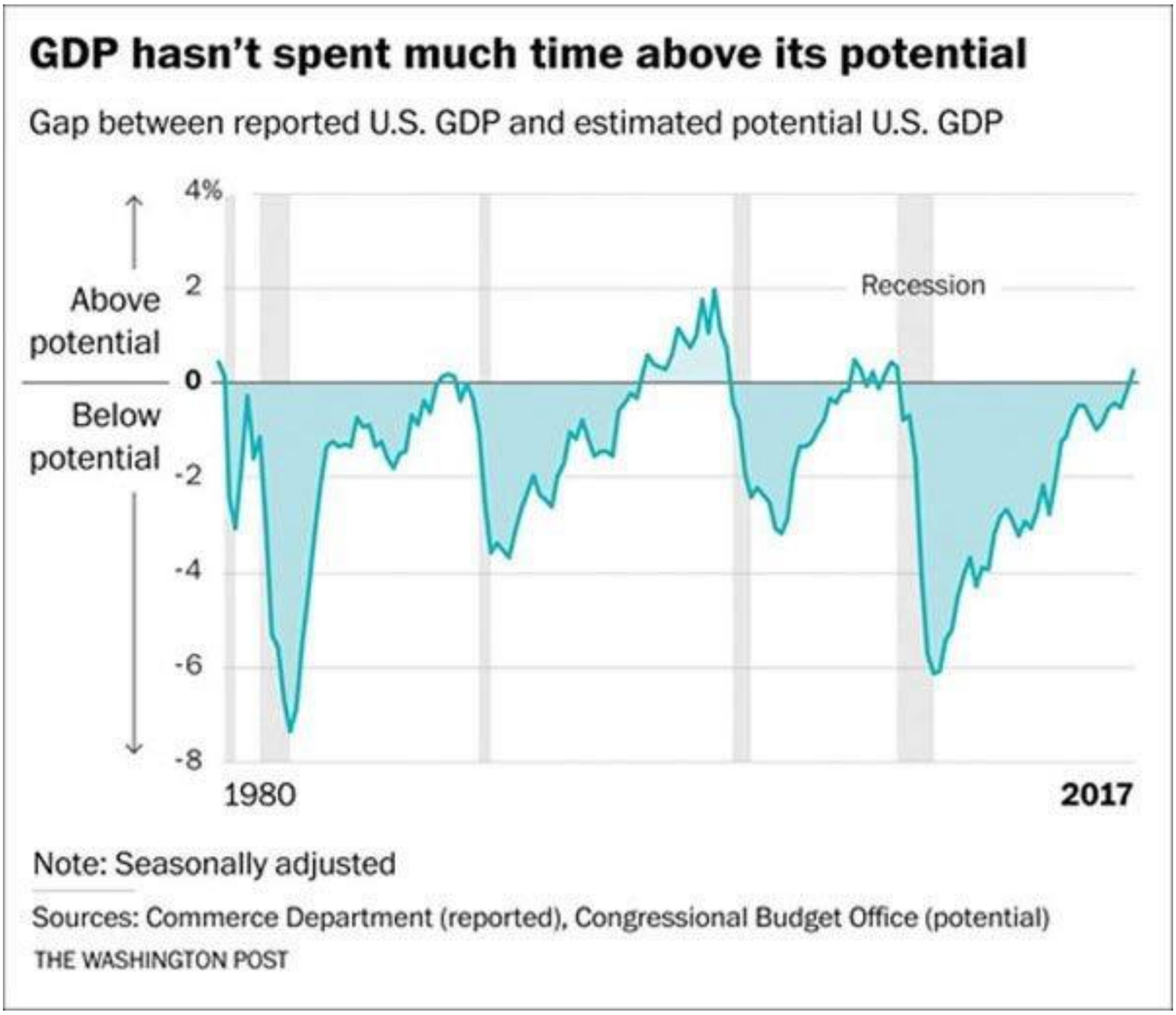
Chart 2: US Bond Yields vs Nominal GDP Growth



2. Declining unemployment in the US or equivalent estimates of a reduced output gap. That is, growth since the GFC has now absorbed excess capacity and further growth would be expected to result in higher inflation (and short-term interest rates as central banks react to the emergence of inflation threats).

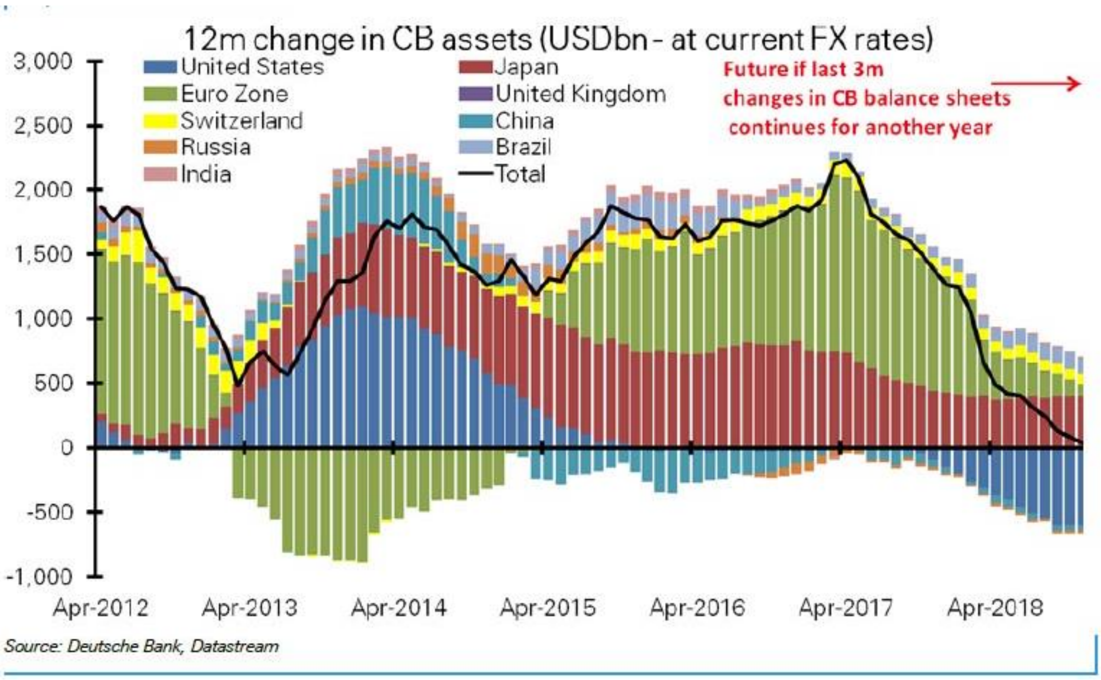
Chart 3: US Civilian Unemployment Rate

Chart 4: US Output Gap



3. Central bank balance sheets are forecast to have peaked in 2017 (assuming the ECB does taper in 2018) and with reduced liquidity from central banks rates will move higher.

Chart 5: Central Bank Balance Sheet Growth



While these are good reasons, at least in the case of the first two – they have been true for some time – and even the potential slowdown in growth in central bank balance sheets has been well flagged (and, hence, if it were going to have an immediate effect on bond rates it perhaps should have started to happen by now).

Against these arguments, part of the reason that rates have remained low are:

- Wage growth across the developed world remains anaemic – which is in stark contrast to the measured unemployment rate or output gap. In the absence of wage inflation, central banks will not rush to increase interest rates. That said, wage inflation (like many employment indicators) is notoriously lagging. If there is a wage breakout it would likely signal that the US Fed was well behind the curve.
- Debt is high. One of the core causes of the GFC was a build-up of excessive debt. While on a sectoral basis there has been some deleveraging (for example, US households) in aggregate there is more debt today. Delevering in some sectors has been more than offset by increased government and corporate leverage. In Australia, the housing boom has seen Australian household debt rise to global leadership levels. In our view, this excessive debt will place a fundamental ceiling on the extent of interest rates rises.

Without wanting to sound like an economist myself, this could be the year that economists are right, but our expectation is that a rise in rates will be modest – as high debt levels limit increases and, hence, rates remain low relative to history for some time to come.