ARTICLE FOR THE EDGE

WHY WE SHOULD WORRY ABOUT RISING INTEREST RATES

Even as equity markets across the world soar to new heights, the bond market has been sending a less exuberant signal. Yields on US 10-year treasuries, a major benchmark rate used in financial markets, have risen to just above 2.5%, almost twice the yield when they reached a trough in the middle of 2016. Similarly, in Europe, the German "bund" yield is at its highest level in about two years. Shorter tenure yields have also risen – the 2-year US treasury bill is now yielding around 2%, its highest level since the financial crisis erupted in 2008.

Yet, the continuing boom in equity prices suggests that many financial investors are not spooked by higher interest rates. While some long time observers such as bond market guru Bill Gross have warned about a new bear market in bonds, others have countered that, on the whole, any rise in bond yields and interest rates generally will have a modest impact on the economy and asset values.

Our view is that global interest rates are set to rise further and will probably reach a point where they will seriously hurt financial markets. Valuations in riskier asset classes including emerging Asian equities will be at clear risk as the year progresses.

The global economy is marching to a very different tune than in the past 10 years

We have been arguing for some time that, fundamentally, the global economy is normalising after ten years of crises and shocks. The evidence since the beginning of the year tells us that that normalisation has strengthened immeasurably in the developed economies while this "normalisation" is also increasingly evident in large emerging economies such as China (about 15% of the world economy) as well as other large emerging economies (around 18% of the world GDP). China's economy has stabilised, with economic growth in 2017 estimated by Premier Li Keqiang at around 6.9%, its first acceleration after steadily easing since 2010. India, Russia, Brazil, Turkey and other sizeable emerging economies are also enjoying brightening growth prospects after years in the doldrums.

Consequently, the high frequency economic indicators released in the past two weeks show global economic activity surging, with lead indicators providing comfort that the vibrancy will be sustained. To us, it is clear that much of the world economy is set to grow faster than its underlying potential growth. And that means the slack in the economy such as unemployed workers and under-utilised capital equipment will diminish faster than markets had expected.

This must mean higher interest rates

A range of factors determine interest rates: central bank policies; the demand for, and supply of, liquidity; inflation expectations and idiosyncratic factors such as risk perceptions. In essence, all these are moving in favour of a sustained rise in rates all over the world.

First, monetary policy will be tightened faster than markets anticipated.

One reason why the bulls and bears disagree is that the bulls do not see this normalisation as enough to change the outlook for global liquidity and bond yields. However, we believe that as the global economy normalises, the "normal" relationships will re-assert themselves – between growth and inflation, between tight labour markets and wage improvement, between capacity utilisation and investment and so on. And, as this happens, the major central banks will no longer be able to justify the ultra-easy monetary policies they have pursued for ten years.

This is becoming clearer by the day. In the past week, some senior decision-makers at the US Federal Reserve Bank have been warning of the dangers of moving too slowly to normalise interest rates. The minutes of the last European Central Bank (ECB) policy meeting also showed ECB officials more optimistic about growth and inflation, a subtle shift that suggested that the ECB was also moving closer to a shift in favour of policy normalisation. Similarly, the Bank of Japan has cut back its bond buying of late.

Even on the current policy track, analysts expect net purchases of bonds by the major central banks to turn negative by the third quarter of the year. Should central banks step up the pace of policy normalisation, the supply of liquidity will decelerate even more.

Second, a turnaround in capital spending by companies will push up the demand for funds.

Surveys of businesses show a rising inclination to step up spending on plant and equipment in many parts of the world. The hard data show accelerated spending on information technology equipment, with semiconductor sales at historic highs and the Fed Tech Pulse Index back to pre-crisis levels. But businesses typically borrow money to fund capital spending. So, as their demand for funds expands, more of the surplus liquidity that has been keeping interest rates low, will flow into the real economy and out of the financial markets. Market interest rates will have to rise in tandem.

Third, inflation will surprise on the upside.

Inflation has been persistently lower than expected for so long that many investors cannot believe that price pressures will finally rise significantly. But the drivers of inflation are in place.

- As global growth will probably exceed its potential growth rate for a second year in a row this year, capacity utilisation will increase and the pricing power of workers and companies will strengthen. On current trends, unemployment, especially in the US, will continue falling. That means wages will finally pick up speed, pushing up business costs. As household incomes rise and confidence improves, companies will overcome the hesitation they felt in raising prices – rising costs will be passed on and consumer prices will rise.

- Commodity prices especially oil prices have been increasing in recent weeks. Oil prices, in particular, tend to shape inflation expectations. All this will also feed into higher inflation.

Risk perceptions could have mixed effects on rates though

Investors have been watching the elevated geo-political risks but have taken the view that the political flash points that have made the headlines – such as the North Korean nuclear issue or the seething tensions in the Middle East or the travails of the Trump Administration or a potential trade war – will somehow not crystallise. We find this view much too complacent: when so many risk factors intensify at the same time, the likelihood is that something will give. Eventually, investors will be spooked and they will demand a higher risk premium. That should lead to higher interest rates as well.

There could, however, be some exceptions to this:

- If geo-politics or some other issue jolt investors, they would tend to rush into safe havens such as the US bond market. Japanese investors will tend to repatriate their funds home if they are worried.

- Another factor to consider is what happens to the so-called savings glut of the pre-2007 days. Then, many observers such as former Fed Chairman Ben Bernanke argued that long term US interest rates had been kept lower by the inflow of funds from countries with huge current account surpluses. Now, we may be returning once again to a world of savings gluts. As the US budget deficit rises and growth accelerates above its potential, the American current account deficit will surge. The counterpart to that will be massive surpluses in China, Germany, and other large exporting nations such as in East Asia. Those surpluses will tend to be deployed in the US bond market, helping to keep yields low.

- Some media reports have claimed that China is re-thinking its approach of investing its foreign exchange surpluses in the US bond market. Since China owns about 19% of foreign holdings of US Treasuries, this could matter. But, does China really have a choice? The US bond market is the deepest and most liquid in the world. Given the scale of China's surpluses, there really is very little option for China but to invest a large part of its growing surpluses in US Treasuries. Interestingly, the data seems to show that virtually all the growth in China's foreign exchange reserves in the first ten months of 2017 went into US Treasuries.

Pulling all these factors together, our sense is that the US 10-year yield could well return to around 3% by the second half of this year – unless there is a huge explosion of political risks. The savings glut could keep a lid on how much the 10-year US Treasury yield can rise but only up to a point. Elsewhere, policy and other market interest rates will rise as well.

Higher rates and the diminished stock of excess liquidity will hit asset valuations – for sure

Fundamentally, asset valuations are derived from discounting the expected cash flows from that asset by an interest rate, usually a long term bond yield. As rates rise, therefore, asset prices must come under pressure – whether we are talking about equity valuations or real estate prices.

And, don't forget liquidity. Our measure of global excess liquidity has just turned negative. This is the amount of liquidity in the global economy that is over and above the needs of the real economy. Thus, it is the liquidity that flows into financial assets. Once this turns negative, it will be difficult to sustain high valuations.

In this new phase of rising interest rates and tightening liquidity for financial markets, investors will tend to look at risks more rigorously. If bond yields in safer, developed economies are yielding above inflation, the frenzied search for yields will ease, and investors are likely to become more discerning. They will demand a higher risk premium over benchmark US rates to hold emerging market bonds and equities.

In short, there is bound to be a re-allocation of capital away from risky assets such as emerging markets to less risky asset classes. Investors will re-assess emerging markets, penalising those countries where asset valuations have not priced in fully vulnerabilities such as:

- Current account deficits that are not financed by stable funding sources such as foreign investment;

- Macro-economic policies such as large budget deficits or loose monetary policies that seem unsustainable; and

- Rising political risks.

Most countries in Southeast Asia have stable external positions and reasonably credible monetary and fiscal policies. However, there is some uncertainty over impending elections in Malaysia and Thailand. By and large, however, the key risk that Southeast Asian countries face is contagion. Emerging markets such as Turkey are at risk of overheating. Should there be some kind of emerging market shock outside the region, global investors could reduce allocations to countries such as Indonesia, Thailand, Malaysia or Vietnam.

In short then, asset markets could well continue to boom for now but the party will not last. The risk of a major correction by the middle of the year is growing.

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