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BEYOND ZERO:

The new order for interest rates

August 2015

The past few years have seen interest rates plummet across most of the globe but, now that recovery is underway in many countries, staying low can interfere with growth.

Many countries, like Australia, are still looking at further cuts to official cash rates while others, like the US and UK, are considering when to increase or "normalise" rates. The US is a key driver of global economic activity and its decision to normalise rates will have implications globally.

Phil Filippelis, Country Head for BNY Mellon Investment Management, explores the impact. Investors can access the BNY Mellon investment strategy through the inclusion of Standish, one of the investment managers in the BNY Mellon suite, in the Advance Diversified Multi-Blend Funds, Advance International Fixed Interest Multi-Blend Fund and Advance Defensive Yield Multi-Blend Fund.

Low interest rates to boost the economy

The official cash rate of a country (the rate of interest charged by central banks on overnight loans to commercial banks) is one of the main tools central banks use to manage their economies. The official cash rate flows on to the interest rates set by banks for consumers with the following options.

> Raising the official cash rate results in an increased cost of borrowing (for example, higher mortgage repayments or credit card repayments) and, in turn, reduces access to funds for consumers (restricting spending).

> Lowering the official cash rate results in lower costs of borrowing and in turn increased access to funds for consumers (encouraging spending).

During the global financial crisis, many countries dramatically cut their official rates to encourage consumer and investment spending to boost their economies. The US dropped down to a range of 0-0.25% by the end of 2008 (by comparison, Australia only recently dropped to 2%).

The US further supported its reduced cash rate by injecting money into the economy through a program of quantitative easing, which started in November 2008. This initially involved the US Federal Reserve (Fed) purchasing mortgage backed securities to help ease funding constraints in the housing market and expanded in March 2009 to include US treasuries (which increased the money supply in the market and assisted in reducing longer-term interest rates). The Fed began tapering its quantitative easing program in February 2014 and the program ended in October 2014.

The recovery process and monetary policy

The US economy has continued to strengthen over the past year meaning the Fed is now starting to consider when to raise the official cash rate. There are a number of factors that will influence the timing of a rate rise.

> Labour market data

> Inflation and inflation expectations

> Wage pressures

> Overall economic growth

> International economic developments.

Of these, the labour market and inflation are primary concerns for the Fed.

The unemployment rate has already fallen significantly, and recent data on employment has been strong.

In terms of inflation, the Fed would prefer to see measures of core inflation move back towards its 2% medium-term target. In recent months, the core rate has been under the target at around 1.3% though this may have been influenced by temporary factors like sudden steep declines in oil prices (which have stabilised to a great extent).

Most market commentators expect the Fed to raise the official cash rate this year, even as soon as September. This however will also depend on the impact of broader market activity, such as volatility in the Chinese sharemarket (which saw global sharemarkets slump in response) or fresh fears that Greece could exit the eurozone.

Implications of a US rate rise

A rate rise will impact the US market in a number of ways, such as reducing the value of many fixed interest assets or increasing the repayment costs on credit cards and aiding the US dollar in moving higher. But it will also affect global markets due to the sheer size of the US market and its relationship with other countries which has meant most financial assets are priced off US markets.

At minimum, there is likely to be some volatility across all asset classes in global markets as both the US and the world adjust to the increased US cash rate and what this means for the value of different investments, particularly bonds and other fixed interest assets. Standish believes US Treasury bonds are closer to fair value than they have been in the past and, as the Fed has confirmed rate hikes are likely to be gradual, any volatility is likely to be short-lived.

Emerging market countries were particularly affected when the US started tapering and may also be affected when interest rates start to rise. Low interest rates, particularly in the US, allowed emerging market countries to access money cheaply to cover their own debts. It also meant international investors, searching for better returns than they were getting currently, looked to riskier assets, such as those in emerging markets. An increase in rates may mean:

- increased cost of debt repayments which would put pressure on those emerging market countries with poorer financial balances and higher inflation
- foreign investors may move their money to 'safer' assets which would devalue emerging markets further as well as decrease funding in these countries.

Translation for fixed interest markets

Naturally, an increase in the official US cash rate will flow on to fixed interest assets and government bond yields are likely to rise in line with this. In turn, existing US fixed interest assets will see their values drop (which can cause capital losses for investors if they choose to sell before the asset matures). The reason for this is, at the most basic level, investors will buy or sell fixed interest assets based on the yield (income) it produces compared with market interest rates. If an investor expects to pay $100 for a bond that offers 0.5% yield based on market rates, then they will not also pay $100 to receive 0.25% yield on a similar type of bond, they will expect to pay a lower adjusted price that may also factor in quality and time until maturity.

Though yields on Australian fixed interest may also rise off the back of a rise in US yields (and therefore see some declines in capital value), the market is still likely to be appealing to investors. The Australian market, even at its current official cash rate of 2%, has a higher rate on offer than other developed markets which has seen many foreign investors buy into Australian fixed interest. A rise in yields and decrease in capital value is likely to be minimised if the Reserve Bank of Australia further cuts the official cash rate.

Time to rebalance

Normalising rates is part of the recovery process for the US and a necessary step, as it will be for other global economies as they start to recover. While the rate rise will cause challenges, there are also opportunities, particularly for Australian fixed interest but also for alternative strategies which may benefit from increased volatility in markets. It also signals a strengthening US economy which may be reflected in its share market and its currency. All eyes will be on the Fed in September for an indication of the start of the rate rises.

Advance monitors US policies as part of its ongoing reviews. Advance expects the US economy to continue to strengthen and for the Fed to increase rates gradually from this year. On the basis of this, Advance has increased the allocation in the Advance Diversified Multi-Blend Funds to international shares, particularly unhedged, to capture this and a stronger US dollar. It also increased the allocation to Australian fixed interest across the year given it continues to benefit from higher interest yield on offer compared to other markets and may benefit further from rate rises in the US.

For more information on the Advance Multi-Blend Funds, please speak to your adviser or call Client Services on 1800 819 935.

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