

Much lower interest rates for much longer

Tim Farrelly | farrelly's | 21 April 2015

What a difference a few months makes. In December 2014, we suggested that Australian interest rates would be around 3% per annum in five years' time and not back to 4% per annum until 2025. We've changed our mind – long-term rates will be even lower – and our long-term cash forecast has been revised down to 3.2% per annum. Our 2025 target PE ratios have increased and we've lowered our long-term forecasts for secure assets.

Why the change of heart – or, perhaps, hardening of heart? Predominately, it has been the market. Worldwide, the interest rates implicit in bond prices have simply collapsed. Sometimes, that is what it takes to join the dots. Sometimes, the information is all there but the penny doesn't drop until the market moves.

SECULAR STAGNATION

This is not a new idea. PIMCO has been talking about it for some time; former US Treasury secretary Larry Summers has been telling anyone who will listen; and we have quoted the work of Reinhart and Rogoff on many occasions. Essentially, the story is that there are two major forces – demographics and government finances – which will act as major drags on economic growth in coming decades.

Long-term growth in demand is essentially driven by consumers. Even business investment tends to occur in order to satisfy consumer demands. As a result, in the long term, growth in demand is tied to consumer spending and consumer spending is tied to income less saving. Consumer income is driven by the size and productivity of the workforce. So, the growth rate of consumption is determined by the growth of the number of workers plus the rate of increase of productivity.

Compare the last 50 years with the next 50 years. In Australia and the US, we had three great forces driving the growth of the workforce – the baby boomers, women entering the workforce, and major immigration programs. Productivity boomed in the wake of technology advances, high rates of investment and a much larger percentage of the population receiving higher education. Savings rates plummeted from around 10% of income to close to zero. These tailwinds all contributed to much higher than normal GDP growth and, because these trends have taken such a long time to play out, 3% to 4% per annum GDP growth has come to be thought of as the natural rate of economic growth.

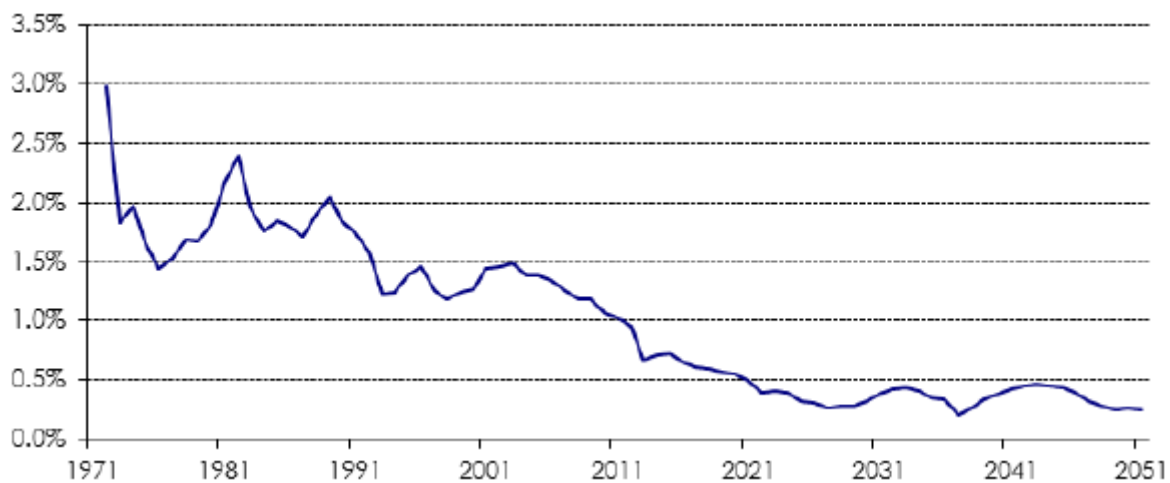
However, with all of these demographic forces disappearing, a number of questions emerge. Just what is the natural rate of economic growth? Can, or indeed should, government

spending take up the slack? Is lower growth bad? And, critically, what is the neutral rate of interest in a slower growth world?

FALLING WORKFORCE GROWTH RATES

As can be seen in Figure 1, the rate of growth in the Australian working age population has fallen dramatically over the past decade and will stay low for decades to come.

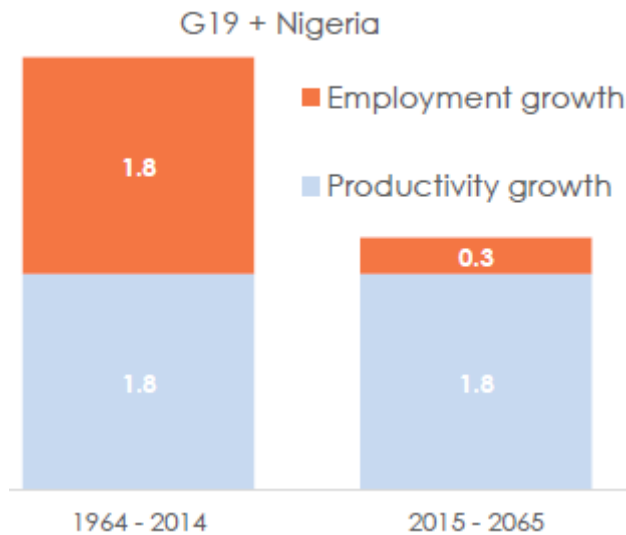
Figure 1: Growth rate of the Australian working age population.



Sources: ABS, farrelly's analysis. As at 1 March 2015.

Unsurprisingly, this is happening all around the world. Figure 2 shows the results of a study by the McKinsey Global Institute which compared past and future growth based on work force growth rates and assumed solid future productivity growth. The productivity assumption is probably an aggressive one. So if these forecasts are wrong, they are probably too high. Even with aggressive productivity assumptions, McKinsey has global growth falling by 40% over the next half century.

Figure 2: GDP growth (%pa) – the past 50 years and the next 50 years



Source: McKinsey Global Institute.

As can be seen in Figure 3, also from McKinsey, for all the enormous technological advances of the past 50 years, GDP growth in the most advanced nations has been at around 1.5% per annum. Those with the fastest productivity growth came from those who start furthest behind. There's little joy in that for the most productive nations, including Australia – despite what we read in the press.

Figure 3: Worldwide productivity growth 1964–2014

Country	Per capita productivity 1964	Per capita productivity 2014	Productivity growth % pa
USA	54	111	1.5
Australia	45	95	1.5
Canada	50	88	1.1
France	35	88	1.9
United Kingdom	35	86	1.8
Italy	33	80	1.8
Germany	32	80	1.8
Japan	17	78	2.8
South Korea	7	70	4.6

Source: McKinsey Global Institute. (Productivity is measured in 2012 US\$'000).

The second major source of slower growth will be public sector savings. Sometime in the next few decades, government debt as a percentage of GDP will be reduced. This is another reduction in the amount of capital available for consumption and therefore another drag on growth.

All combine to make a very good case for much lower growth in the developed world over the next three to four decades... Welcome to the new normal!

IMPACTS OF LOWER ECONOMIC GROWTH ON INVESTMENT MARKETS

The first area that springs to mind is EPS growth. Oddly enough, we anticipate that lower GDP growth will have very little impact on EPS growth. Companies will adapt to this environment and adjust their capital spending accordingly. Lower capital spending amounts to less need for share issuance and more buybacks. Earnings will grow more slowly, but earnings per share should grow much as before, and it is EPS that we care about.

The really big impact on investment markets looks as if it will be via much lower real interest rates which have collapsed all around the world over the past quarter. The big question is "Just how low will rates go from here?" Is this just a temporary fall or is this where we will be for decades? Where do we get a good guide?

In more recent times, Japan seems to provide a possible road map. In Japan, as growth slowed, real rates went to zero. In Europe, we have the makings of a repeat. If, indeed, zero real rates will be the way of the future, we should expect to see cash rates in Australia average around 2.5% per annum in the years ahead.

The market clearly thinks that low rates will be with us for a very long time, as shown in Figure 4 which presents real rates available on inflation-linked bonds (ILBs). Given that investors generally want a premium for locking in rates, we have taken a little off the ILB yields to arrive at estimates of the market's expected real and nominal cash rates for the next decade.

Figure 4: Real rates on 10 year Inflation-linked Gov't Bonds and estimated cash rates

Country	Australia	NZ	Germany	Japan	Per capita productivity 1964	Productivity growth %pa
Real rates	+0.5%	+1.8%	-0.5%	-0.5%	-0.7%	+0.7%
Expected real cash rates	+0.2%	+1.3%	-0.7%	-0.7%	-0.9%	+0.5%
Market forecast cash rates	2.7%	3.3%	0.3%	0.3%	1.1%	2.0%

Source: Barclays Capital, farrelly's estimates. As at 1 March 2015.

These rates represents a dramatic change from those which we have come to think of as "normal". As shown, the market rates imply average Australian cash rates of around 2.7% per annum over the next decade. Even the Reserve Bank of Australia, until February at least, considered that 2.5% per annum cash rates were extremely accommodative. Perhaps that is now just going to be close to average.

Our estimate for Australian cash rates is a little higher than the market's, at 3.2% per annum – but only just. The market's estimate for New Zealand cash rates is in line with farrelly's estimate.

This will all require a huge change of thinking. Looking back at average real returns from cash over the past 100 years shows just how unusual the last 30 years have been. The idea of positive real interest rates, which we have grown used to since the 1980s, is actually something of an outlier, as shown in Figure 5.

Figure 5: Cash real returns (%pa) over the past 100 years

Period	Australia	Canada	Japan	UK	US
1910 – 1980 ¹	-0.9	+0.7	+0.2 ¹	-0.2	+0.1
1980 – 2000	+4.9	+4.8	+1.5	+4.5	+2.8
2000 – 2014	+1.9	+0.4	+0.7	+0.2%	+0.6

Source: Dimson Marsh & Staunton, *The Triumph of the Optimists*. Note: Japanese data is from 1950 – 1980 to eliminate impact of the war years.

Low GDP growth, very low real rates, higher PEs and valuation multiples – it's a new world – a new normal – and we all need to get used to it! In particular, it will require that we review client spending plans. Lower rates means less money to spend. It's a good time to review investors' overall financial positions.

Tim Farrelly is principal of specialist asset allocation research house, [farrelly's Investment Strategy](#), available exclusively through PortfolioConstruction Forum. The above is an abridged extract from the 1 March 2015 farrelly's Investment Strategy Handbook. Tim is a member of [PortfolioConstruction Forum's core faculty](#) of leading investment professionals.

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