CAPITAL ECONOMICS

commissioned by IQEQ

Look towards equities as another decade of low real interest rates lies ahead

November 2021

Introduction

Interest rates have been at historic lows for over a decade and most of the factors that have driven down equilibrium interest rates since the 1980s are likely to stay in place for the foreseeable future.

Against this backdrop, we have asked leading independent economic research firm, Capital Economics, to analyse the impact of low equilibrium interest rates on the asset markets.

Why is research into equilibrium interest rates needed? Simply put, whilst the equilibrium real interest rate may not sound like the most exciting of economic topics, it is of considerable importance to investors. It underpins borrowing costs and returns across the whole economy. It ensures that planned investment balances, predictable risk and asset pricing, and that inflation is stable around central bank targets.

Reflecting the importance of the issue, this article takes a deep dive into the reasons behind the fall in long-run real interest rates since the 1980s and examines what will be the evolution of savings and investment rates moving forward. And finally, the article looks ahead to why a decade of muted returns likely lies in store for more traditional asset classes. A significant trend as it points towards a potential intensification of the search for yield in financial markets.

We look forward to engaging in further conversations on the issues that count as the industry evolves. We would be pleased to hear your comments and feedback on this opinion piece.

To keep in touch with industry insights such as this why not sign up for our newsletter and follow us on LinkedIn and Twitter for details of our upcoming webinars, insights, and events. You can also subscribe to our podcast on Spotify, Apple Podcasts or Google.

Justin Partington
Group Head of Funds

Equilibrium real interest rates underpin borrowing costs and returns across the whole economy

Equilibrium real interest rates. They hardly sound like the most exciting of economic topics, however they are of vital importance to investors as they underpin borrowing costs and returns across the whole economy. We expect the equilibrium level of real interest rates in the global economy to not remain quite as low as of late, but any rise should be gradual and small. We examine what this will mean for asset markets.

The equilibrium interest rate, also called the neutral or natural rate, refers to a long-run interest rate that keeps the economy growing in line with its potential. In essence, it ensures that planned investment balances desired savings and that inflation is stable around the central bank's target. In the long run, the equilibrium rate is anchored by the amount of supply in the economy and is therefore related to potential GDP growth. Factors that affect desired savings and investment can move it away from its anchor temporarily – albeit some of these may apply for decades. The rate is itself unobservable and accordingly has to be inferred by looking at movements in actual interest rates and inflation.

Increased savings and decreased investment lay behind the fall in long-run real interest rates since 1980s

Actual real interest rates have fallen steadily in both developed and emerging markets since the early 1980s, but this was more pronounced in the former. At the same time, low rates did not generate inflation, pointing towards a fall in the long run equilibrium interest rate. Several structural factors that created a global excess of desired savings over desired investment account for this.

For three reasons, the propensity to save has increased over time for any given level of interest rate. First, populations have aged, particularly in developed economies. Lower fertility rates combined with rising life expectancy and a large share of the population being in the prime age range for saving (40 to 60 years old) have raised the level of desired savings. Second, China, Germany and many oil-producing countries have seen increasing savings rates since the 1980s and are key factors behind a 'global savings glut'. This was exacerbated by deleveraging in Asian countries after the Asian financial crisis in the late 1990s and more widespread globally after the GFC 2008/09. Third, over the years wealth has become more concentrated in the hands of the well-off, who typically save a higher proportion of their income than the less well-off do.

Simultaneously, global desired investment for any given level of interest rate has decreased over time. This is because the relative price of capital goods has fallen, and corporate short-termism has become more prevalent. Furthermore, the growing importance of the less capital-intensive services sector for most developed economies has reduced the investment needed per unit of GDP. Lastly, increased risk aversion has contributed to a further decline in the wake of the GFC.

Together, these factors have more than outweighed any offsetting upward pressure on equilibrium interest rates stemming from, for example, higher government debt levels. They have culminated in current real interest rates that have been at historic lows for several years.

Equilibrium interest rate could rise slightly by 2030 but policy rates to remain low by historical standards

Before the COVID-19 pandemic, the equilibrium long-run interest rate was very close to zero in most advanced economies – between 0 and 0.5 per cent in the US and the UK, and possibly negative in the euro-zone. This compares to 3 per cent in the 1980s according to the IMF.

Short-term impacts of the pandemic notwithstanding, most of the factors that have driven down equilibrium interest rates to very low levels since the 1980s are likely to stay in place for the foreseeable future. We doubt we will see major shifts in desired saving, as the effects of an ageing population will offset each other; rising longevity may prompt the working-age population to save more for an expected longer retirement, while the increasing number of pensioners will result in more 'dissaving'.

On the other hand, there may be some potential for a rise in desired investment. Insofar as recent substantial climate change pledges by governments across the world translate into further public investment, the interest rate could see upward pressure. Moreover, higher engagement in the digital economy, as a legacy of the coronavirus crisis, could boost investment – as could technological progress, albeit the latter's timing is more uncertain. Overall, we only expect a limited and gradual rise in equilibrium real interest rates, rather than a sharp and abrupt pick-up. Based on the view that the equilibrium rate in advanced economies is currently around zero, a rise to between 0.5 and 1 per cent over the next two decades is possible.

Against this backdrop we expect policy interest rates and bond yields to remain low by most historical standards. Admittedly, there has been a more hawkish shift among central banks recently as inflation has surprised to the upside. But we expect the bulk of these price pressures to ease as supply chains adjust and commodity prices ease during next year. In any case, central banks today have had to become more tolerant of higher inflation because of the increasing importance given to mandates such as full employment and high levels of debt in their respective economies. The latter point also suggests a predisposition of central banks towards cautious and slow nominal policy rate rises. When nominal rates lag inflation, real rates are kept negative and act as a means to 'inflate away' government debt– a method known as financial repression.

Challenging investment environment ahead may lead investors to search for alternative opportunities

A continued low equilibrium and thus risk-free interest rate will keep asset valuations above their historical average, with returns lower than their historical average. As long as inflation does not spiral out of control and trigger aggressive intervention by central banks, we expect cash, bond, and commodities returns to disappoint in this decade. Equities returns should do well, but underperform relative to the past few years' average.

Returns on cash will be meagre over the next decade as the policy rate remains fairly low. We expect the federal funds rate in the US to rise to around 2.5 per cent in 2030, and 1.5 per cent in the UK and euro-zone. In addition, given inflationary pressures, the multi-decade bull run in developed markets' government bonds will likely come to an end. Amongst developed economies, the probability of sustainably higher inflation is highest in the US. We project 10-year US government bond yields rising by more – and their real returns being a bit worse – than in the euro-zone or the UK. In the US, we forecast an increase in the 10-year yield by 2 percentage points between 2021 and 2030 to 3.8 per cent, compared to a 1.4 percentage point rise to 2.4 per cent for the UK. Moreover, as inflation compensation rises in developed markets, long-dated TIPS should outperform Treasuries.

High-yield and investment grade corporate bonds should still comfortably outperform 'safe' sovereign bonds in this

decade. However, with spreads close to pre-GFC lows, there is limited scope for riskier bonds' returns to be particularly strong. Historically, corporate bonds have performed poorly when spreads were as tight as they currently are.

We anticipate commodities will exhibit negative returns over the next ten years. The price of most commodities should fall in the near term as supply shortages ease off. And in light of an accelerating green energy transition, the oil price should continue to drop thereafter. Furthermore, we expect a structural slowdown in the Chinese economy to weigh on industrial metals prices. For this reason, roll returns – the cost/benefit of rolling over short-dated futures contracts – should continue to act as a drag on total commodities returns in this decade.

These expected drops in prices of commodities will pose headwinds for equities in commodity intensive economies, particularly for Brazil, whose stock market is highly sensitive to the price of iron ore. Nevertheless, the long-term outlook for equities is brightest amongst the asset classes. Current stretched valuations coupled with some tailwinds from recent years that are likely to unwind – such as corporate tax rate cuts and looser antitrust policy in the US – however, make another 'roaring 20s' unlikely.

We expect that due to a valuation gap, US equities will underperform other key markets, whose equity valuations are high by past standards, but still below US peers. EMEA should be among the top performing regional markets, as well as Latin American equities. The latter are expected to hold up as non-energy and materials companies' low valuations and considerable scope in profit margins should help offset any weakness in those sectors.

Overall, we expect a decade of lower returns lies ahead for more traditional asset classes, pointing towards a likely intensification of the search for yield in financial markets. In general, we expect returns to fare slightly better outside the US given more favourable initial valuations there. As such, we expect to see a renewed move towards riskier (leveraged) and alternative (less liquid) assets, such as more complex structure financial products and infrastructure investments. The latter in particular offers long-term, stable and predictable cash flows and can also act as a hedge against inflation. We also expect to see a continuation of the trend towards more climate-focused investing, based on environmental, social and governance (ESG) principles, as there is an increasing recognition that these factors are important, particularly for infrastructure investment.

This report has been commissioned by IQ-EQ group. However, the views expressed remain those of Capital Economics and are not necessarily shared by IQ-EQ group. While every effort has been made to ensure that the data quoted and used for the research behind this document is reliable, there is no guarantee that it is correct, and Capital Economics Limited and its subsidiaries can accept no liability whatsoever in respect of any errors or omissions. This document is a piece of economic research and is not intended to constitute investment advice, nor to solicit dealing in securities or investments.

Reference: SNDE316_18112021
© Capital Economics Limited, 2021.