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Navigating the Low Interest Rate Environment

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Navigating the Low-Rate Environment

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Artificially low rates are causing multiple price distortions and pockets of heightened risks. And while the current environment may be unprecedented, it need not be incomprehensible. In this multi-part series, we discuss this environment—and explain why investors who understand the dynamics driving low rates may be positioned to take advantage of promising opportunities.

Sovereign bond yields have been plunging toward zero and have even reached negative territory in parts of Europe and Japan. As a result, bonds in those markets look highly unattractive and seem to offer a great opportunity to short and potentially earn a handsome return as prices revert back down toward fundamental value.

Several equity markets are similarly unattractive (or less attractive than they might be in a more normal rate environment). However, as we will explain, in this environment it might take a long time for their prices to reach fundamental values, and we are cautious about shorting bonds and equities as a result.

Valuation is the first stage in our process of analysis. In this stage, we ask ***Where*** discrepancies exist between price and value.

When we identify price discrepancies like the ones we've described, we embark on the second stage in our process and ask ***Why*** prices are diverging from fundamental values. For example, we want to explore ***Why*** global interest rates are at historically low levels (and have been for some time) in order to better understand when rates might normalize.

This understanding is key to the third stage in our process, which guides us in ***How*** to respond to these opportunities as macro investors.

As we have previously explained, we see loose monetary policy as a main driver of pricing in the current environment. In our blog post series, Navigating a Troop of Gorillas*,* we laid out the effects of loose monetary policy on market prices, volatility, and market structure. We also analyzed how loose monetary policy conspires with market regulations and rules-based investment strategies to create a fragile market environment susceptible to illiquidity events.

When writing that piece, we were facing a “troop of gorillas” in the form of central banks distorting markets with artificially low rates. We are now living on the “planet of the apes,” where low rates are used as the ultimate tool for all problems, including the negative supply shock caused by the new coronavirus.

In our new “Adventures on the Planet of the Apes” blog series, we provide a deeper understanding of the causes and consequences of the current low interest-rate environment, which helps us better anticipate moves in markets and currencies and properly navigate them.

An artificially loose monetary environment leads to misallocations of resources that can take a long time to unwind. The current slow rate of growth among developed countries is likely driven in part by the multiple distortions created by perpetually overactive (and overwhelmingly stimulative) monetary policies.

Regardless of central bankers’ beliefs about the drivers of long-term economic growth, their incentives are to introduce and support economic stimuli in the shorter term. And while central bankers try their best to push up inflation, inflation itself is not a component of a healthy economy.

Unfortunately, the active pursuit of inflation is likely to eventually give policy makers too much of what they are asking for.

In anticipating future developments, we must realize that the political impetus of governments and central banks may not be in line with normalizing economic conditions that allow prices to find their fundamental values. Policy makers will allow the system to change only when it becomes politically expedient. Therefore, we expect the current environment of low interest rates to likely prevail for some time.

Alas, the kinds of policies that may follow this low-rate period are unlikely to be for the better.

We will likely see a large shift from monetary policy to fiscal policy as the primary source of economic stimulus within the coming decades. Prior to the coronavirus outbreak, we believed this was unlikely to happen until rates had been pushed down even further, in particular in the United States, where there still remained room for multiple rate cuts. Since the outbreak, these developments have played out in rapid succession as several rate cuts have been implemented and fiscal measures have been engaged in great measure to help support economies not only in the United States but around the world.

On the back of this analysis, we have lengthened the interest rate and inflation convergence times in our valuation model from 8 to 12 years. Yet, we retain our eight-year convergence period for equities as we cannot conclude that central banks have the same kind of direct control over these as they do over short-term rates.

In this series, we start by attaining an understanding of interest rates through the lens of the natural-rate concept and look at why rates and inflation are low. We then discuss why and how the current regime of loose monetary policy might end, and conclude with the implications this analysis has for our investment portfolios.

Adventures on the Planet of the Apes Blog Series
Part 2: Nothing Natural About Low Rates
Part 3: Why Rates Are Low
Part 4: Where Is the Inflation?
Part 5: The Death of the Inflation Regime
Part 6: Beyond the Inflation Regime Collapse
Part 7: Rates: Lower for Longer
Part 8: 6 Negative Consequences of Low Rates

What Do You Think?
In a future post in this series, we will explain why we believe a monetary regime can sustain itself without support from economic fundamentals as long as people do not realize it is set for a fall—much like the cartoon character Wile E. Coyote running off a high cliff only to plummet once he realizes he is no longer on terra firma. The study of Wile E. Coyote's motion provides clues to various aspects of market behavior.

Considering all you know about quantum physics, we solicit the response to the question: **Does gravity exist before you observe it?** Please submit your response by June 30, 2020 to DASteam@williamblair.com. We will post the best responses to the William Blair blog. William Blair employees are excluded.

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