Long-term interest rates: Up, sideways or down?

It came as a surprise to us that the long-term policy rates rose in the second quarter, and the increase was substantial. The yield increases on the most secure government bonds pulled up the long-term interest rates generally.

The US ten-year bond yield increased from 1.9% to 2.4% while the German equivalent rose from 0.2% to 0.8%. The interest rate in these countries thereby returned to levels last seen in October and November of last year. We had positioned our bond fund SKAGEN Tellus in line with our expectation that the long-term interest rates would either remain stable or fall.

So how do we see things developing further? Will the interest rates continue to rise, will they remain at around the same level we see today or will they decline again?

Active bond fund management – i.e. trying to generate excess returns for unit holders over time by having a view on whether interest rates will rise or fall, both generally and in various markets – implies that one has an opinion on what is most likely to happen in future. Often this entails having a view that deviates from the consensus. This appears to be the case now when most analysts are of the opinion that the policy rates will rise further. We still believe they will fall.

Interest rates and inflation will fall

The reason that we believe interest rates will fall further is due to a combination of our view on growth prospects and our view on inflation developments. The long-term interest rates can be broken down into a real rate and compensation for expected inflation. The upturn in the long-term interest rates last quarter was due to the fact that the real rates increased and expected inflation picked up both in the US and in Germany. The US 10-year policy rate increased by about 50 basis points, i.e. 0.5 percentage points. Of this, the real rate contributed 30 basis points and higher expected inflation 20 basis points. The developments were more or less the same in Germany, but starting from a lower level.

The increase in the real rates probably reflected the better growth prospects in the advanced economies. The market saw through the weak first quarter figures and priced in expectations of higher growth both in the US and the Eurozone. This may be correct. So far the current indicators generally give an indication of better growth in the advanced economies beyond 2015 than was the case in the first quarter. An important factor here is likely lower energy prices due to a greater supply of oil.

On the other hand, we believe that the heightened inflation expectations are transitory; it is most likely that there will be another downward correction. Inflation will wane, and gradually this will have an impact on expected inflation. We are therefore of the opinion that so-called expansive monetary policy has the opposite effect in the long run. Without going into the theory, we refer to experience. In Japan, many years of a zero interest rate policy have not resulted in a sustained increase in inflation.

Japan has for years been brushed aside a peculiarity, but the same economic mechanisms apply there as in other developed economies. And now we are also beginning to see the same developments in other advanced economies. In the Eurozone, core inflation has so far this year had an annualised rate of 0.4%. One may well claim that this is because economic growth has been sluggish, but we do not share this view. Switzerland is an example where inflation is negative. One may object that although the economy has seen fairly good growth, inflation is currently effected by a strengthening currency earlier this year. This is not a view we subscribe to either.

Building on observations

One reason why we are sceptical to the typical explanations around inflation developments in the Eurozone and Switzerland is experience from other economies that have practised zero interest rate policy. If we look at the developments in the UK and Switzerland, we see that inflation has declined at the same time as monetary policy has been extremely expansive and economic growth healthy.

If any one country stands out, it must be the US. Inflation here has also admittedly been low – so far this year core inflation has grown at an annualised rate of 1.3% – but it has been low a good while without yet showing signs of stabilising around zero. Compared to what has happened in Japan and the other economies mentioned above, we believe it is merely a matter of time before inflation falls further towards zero in the US also. A trigger may be if the Fed increases the interest rate towards the end of the year.

The short-term policy of a slightly tighter monetary policy in the US is slightly lower inflation. If the Fed then stops after an increase of 25 basis points, or retreats, then they'll be back to a zero interest rate policy. Overall, both the long-term effect of the Fed policy since 2009, and the short-term effect of a slightly tighter monetary policy, point to lower inflation.

The conclusion when it comes to the long-term nominal interest rates is therefore that lasting low inflation will in time rub off on inflation expectations. This will in turn cause the long-term interest rates to fall as we do not believe there is further acceleration in economic growth to be priced into the long-term real interest rates.

– Torgeir Høien
Portfolio Manager SKAGEN Tellus