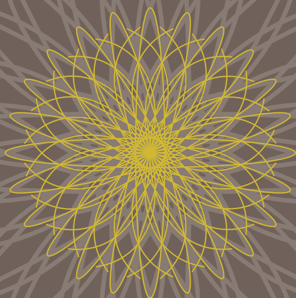

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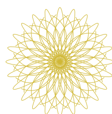

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Entrust Investment Views

Interest Rates Are Moving Higher

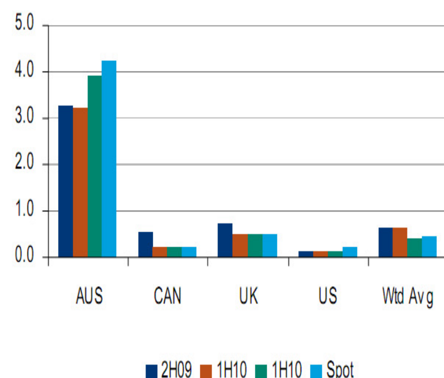
Key Points:

- Central Banks are phasing out "quantitative easing" and liquidity programs.
- Next step: higher short-term interest rates as economies recover.
- Global bond rates have risen to their highest levels since the collapse of Lehman Bros.
- Record debt issuance to finance budget deficits / sovereign debt concerns to get worse.
- Implications of higher interest rates for Australian investors: mainly positive.

Low Interest Rates And Fiscal Stimulus Have Worked – The Emergency Is Over

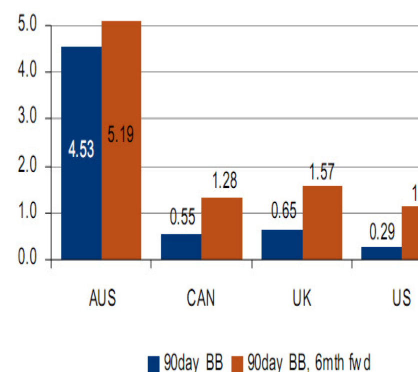
In late 2008 central banks responded to the then very real threat of a collapse of the global financial system in the wake of the Lehman bankruptcy by adopting ultra-accommodative monetary policies, including record-low official interest rates, unlimited access to liquidity and direct central bank purchases of government bonds and other securities in the financial market (so-called quantitative easing). Governments chipped in with bank bail-outs and massive fiscal stimulus measures to stop a free-fall in economic activity. 18 months later we can see that the immediate objectives of re-establishing functioning financial markets and of restarting economic growth from the lower base have been achieved, albeit at a heavy cost to the fiscal balance of many developed economies.

Chart 1: Central Bank Cash Rate Targets



Source: Bloomberg, Merrill Lynch

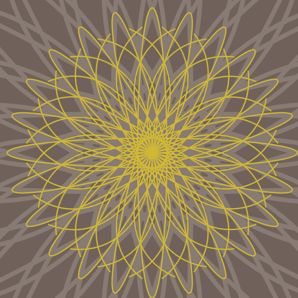
Chart 2: Bank Bill Futures - Rate Rises by End CY10



Source: Bloomberg, Merrill Lynch estimates

As the global economic recovery broadens, the merits of holding official interest rates at emergency levels are increasingly being questioned. Australia is leading the small, but growing club of countries that have lifted official cash rates – in our case by 1.25% from the low of 3.0%. The Reserve Bank has indicated that it doesn't consider the job done just yet and investors agree: 90-day bank bills price in a move above the long-term average cash rate of 5% by early 2011 (see Charts 1 & 2).

Other countries are not yet ready to lift rates, but have started to reign in liquidity by raising reserve requirements (China) or completing quantitative easing programs (USA, UK). While the majority of policy makers hesitate, futures markets already anticipate a rise in official US & UK cash rates by the end of the calendar year (Chart 2).



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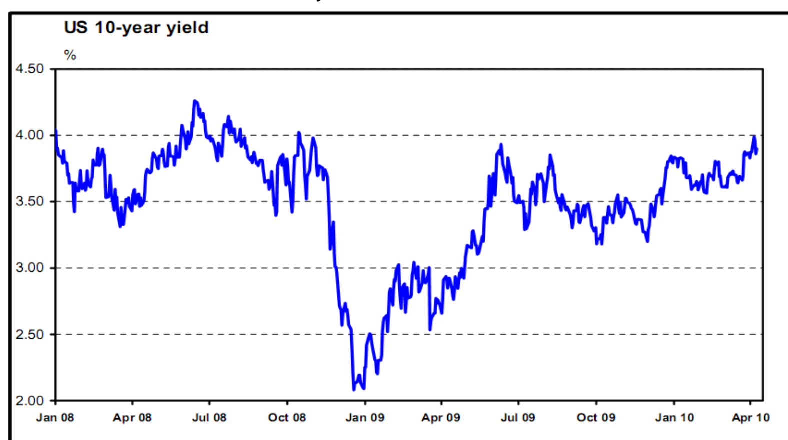
Global Bond Yields At Highest Levels Since Lehman Collapse

Confidence has undergone a remarkable transformation over the last year: Investors have recovered their poise and gone from almost total risk aversion in late 2008 to a renewed hunt for yield in corporate fixed interest securities. Sharemarkets have rallied sharply. Companies are rebuilding their depleted inventories and have dusted off capital expenditure plans.

Government bonds are no longer the only game in town. Indeed, from being highly sought after, they've become more and more abundant as record high budget deficits result in a constant stream of high-volume issues (the US Treasury alone needs to raise an average US$50bn in new debt each week to fund the projected federal budget deficit of US$1,300bn, not counting re-financing of maturing debt and agency debt). The competition for funds explains why US 10-year bond yields have doubled from 2% to 4% recently (Chart3), even in an environment of ample and cheap liquidity.

Chart 3: Yield on 10-Year US Treasury Bonds



Source: Chris Caton, BT Financial Group

Another issue is now also getting more attention: sovereign credit risk. Greece's debt problems have been well publicised. Of more importance, though, is rapid deterioration of the US financial position: Over the last two years public-held US federal government debt has grown from US$5,105bn to US$7,788bn – or from 35% to 55% of GDP. A further increase is unavoidable under current policies. We've already reached the stage where high quality US corporate borrowers can raise funds at cheaper interest rates than the US government. The public finances of other major developed countries (e.g. UK, Japan) are in even worse shape than that of the USA.

In our view, market interest rates are heading higher under almost all scenarios. A stronger economy will increase the competition for funds between the private and public sector. At some stage, investors will demand higher returns to protect against the potential for higher inflation. Any relapse in activity will bring sovereign risk concerns to the fore and investors will be looking for higher risk margins.

Implications For Australian Investors

- Rising interest rates are primarily an indicator of a broadening recovery in the global economy. In the early stages of a rate rise cycle the net effects are broadly supportive for a commodity-intensive country such as Australia.
- The domestic economy should continue to benefit from strong demand and higher prices for commodities for most of 2010, but developments in China will remain crucial.
- The Aussie Dollar should remain well supported by the boost to the balance of payments from higher bulk commodity prices and the high – and potentially growing – yield gap.
- Equity valuations will come under downward pressure as interest rates rise further, but this negative effect should be more than offset by the rise in earnings over the next year.
- Investors are likely to move more towards quality growth stocks that have underperformed over the last year due to their lack of leverage to the economic recovery. Mid- to late cycle sectors (e.g. media, transport, business services) also look attractive, while interest-rate sensitive stocks (housing; discretionary consumption) will struggle to keep up the pace.
- Income-oriented investors can look forward to higher returns on their funds. Fixed interest investors should concentrate on variable rate securities, such as hybrids. In our view, fixed rate corporate and government bond prices face downward pressure as yields rise, making near-term total returns unattractive.

- Domestic share prices have moved to the top of the broad 4500-5000 trading range for the ASX200 index. This has once again eroded near-term valuation support and left share prices vulnerable to a correction. Economic data, a further tightening of monetary policy and corporate and/or sovereign debt problems are potential catalysts for a sell-off.
- We expect Australian equities to eventually work their way higher as corporate earnings catch up with the appreciation in share prices. However, the near-term upside appears limited as most of the good news is already priced in.

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