Record Low Global Interest Rates and its Implications on Asset Allocations

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What a bizarre world we are living in! Economic theory has always taught us that there exists a zero lower bound for interest rates i.e. interest rates cannot be negative. But even as I write this, there are currently US$12.9 trillion outstanding amount of bonds yielding less than 0%. Infact, nearly 40% of all developed market benchmark bonds are now trading in negative territory and in Switzerland, every single government bond has a negative yield! This begets the question – why are global interest rates so low? Two important factors which have contributed to the significant decline in interest rates in the last few years are:

1. **Low growth:** The structural headwind of the "3 Ds" – Debt, Deleveraging and Demographics have resulted in sub-par growth post the Great Financial Crisis (GFC). The reluctance of the three economic entities (households, government and corporates) to expand their balance sheets, the unwinding of global trade, a rapidly ageing society and declining productivity of each incremental debt taken, have all contributed to a sharp decline in global over the last few years
2. **Low inflation:** Global excess capacities (a direct fallout out of the "animal spirits" of the last decade) and less commodity intensive nature of current growth has led to a series decline in inflation in both developed markets (DM) as well as emerging markets (EM)

However, a third factor which has perhaps been the biggest contributor to the stupendous decline in global rates in recent years is the "unconventional" policies of major Central Banks. Ever since Paul Volcker's spectacular use of monetary policy to break the back of hyperinflation in the 1970s and 1980s, Central Banking has been considered to be the panacea of all our economic woes. With the onset of GFC, major Central Banks looked further set to augment their "rockstar" status. Pulling new policy tools from their hat, they tried to engineer "escape velocity" from what certainly looked like a second Great Depression. However, while their "unconventional" policies have failed to generate the desired growth and inflation, the relentless purchase of treasuries by Central Banks via QE have led to an unusual decline in rates via a depressed term premium. Infact, even though the Fed has ended its asset purchase program, the ECB and the BoJ are currently buying ~US$180bn of assets per month, a larger global total than at any point since 2009!

Table 1: Matrix of Gsec rates of various developed markets. Negative rates galore

The Matrix: Race to Negative Bond Yields													
Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-0.83	-0.86	-0.94	-0.92	-0.86	-0.79	-0.74	-0.65	-0.57	-0.53	-0.31	-0.18	-0.04
Japan	-0.22	-0.19	-0.19	-0.18	-0.19	-0.19	-0.20	-0.18	-0.14	-0.09	0.07	0.29	0.39
Germany	-0.60	-0.62	-0.65	-0.60	-0.52	-0.49	-0.43	-0.32	-0.20	-0.07	0.05	0.25	0.43
Netherlands		-0.59	-0.61	-0.58	-0.44	-0.42	-0.34	-0.21	-0.08	0.03			0.50
Finland	-0.57	-0.59	-0.58	-0.49	-0.46	-0.36	-0.28	-0.19	-0.07	0.07	0.32		0.52
Austria	-0.53	-0.52	-0.52	-0.51	-0.45	-0.41	-0.38	-0.33	-0.05	0.10	0.03	0.51	0.76
France	-0.56	-0.55	-0.53	-0.48	-0.40	-0.35	-0.24	-0.14	0.02	0.16	0.49	0.75	0.93
Belgium	-0.6[illegible]	-0.58	-0.55	-0.52	-0.46	-0.38	-0.29	-0.12	0.03	0.17	0.52	0.59	1.03
Sweden	-0.5[illegible]	-0.66		-0.54	-0.54	-0.40	-0.27	-0.09		0.12	0.60	0.97	
Denmark		-0.49	-0.15		-0.29			-0.12		0.09			0.50
Ireland	-0.42	-0.42	-0.35	-0.27	0.00	-0.10	0.03	0.20	0.33	0.43	0.73		1.18
Italy		-0.10	-0.04	-0.03	0.20	0.25	0.48	0.30	0.79	0.94	1.26	1.49	1.49
Spain	-0.25	-0.17	-0.09	-0.01	0.14	0.22	0.43	0.73	0.86	1.02	1.32		2.06
United States	0.54	0.72	0.85		1.14		1.41			1.59			2.31

This brings us to the next pivotal question – how much further down can global interest rates go? As we know, DM yields have seen a sharp decline since the beginning of 2016. The decline got exacerbated post the Brexit event with the US 10-year note falling to a new low and through its 2012 nadir while German 10-year bunds moved into the negative territory. However, even as yields have recently come off from their post-Brexit lows, they still remain below their pre-Brexit levels. Our assessment of the current macro environment seems to suggest that global yields have most likely found a bottom. We base our arguments on the following:

1. **Bond markets currently seem to be overestimating recessionary risks:** The current growth rate of the US economy does not warrant such low interest rates. Infact, a hallmark of the current economic cycle has been that while overall growth has been low, it has also been remarkably stable – global GDP growth has remained bounded close to 2.5% for the last four years despite a multitude of shocks
2. **Bond markets currently seem to be underestimating inflation pressures:** There seems to be a growing disconnect between the rebound in global commodity prices and subdued inflation expectations. The US looks set to lead the global reflationary trend, driven by price increases in the service sector and tightening labour markets
3. **Increased probability of fiscal easing:** There is a growing acceptance that monetary policy is losing its effectiveness as yield curves are already flat, the private sector is unwilling to borrow even at such low rates and negative interest rates are hurting financial institutions. With monetary policy now running out of ammunition, expectations of fiscal easing are rising:
   - ✔ Japan recently announced a US$270bn fiscal stimulus package
   - ✔ In Europe, the growth of government spending has accelerated back to its pre-GFC pace (note that the ECB cancelled Spanish and Portuguese fiscal rule-breach fines in the past month)
   - ✔ In the US both presidential candidates are touting infrastructure spending packages (Clinton proposes US$275bn in infrastructure spending over five years while Trump has also proposed tax cuts, infrastructure and health spending)

All the above factors suggest that bond yields look unlikely to fall further from their recent lows. However, it is important to note that the rise in yields is likely to be very moderate and gradual as monetary policy is likely to remain accommodative for a considerable length of time.

What are the cross-asset implications of the above? Post-GFC, global bond funds have seen inflows of US$1 trillion, almost three times the flows into global equities in the same period. The trend in the last couple of years have been particularly egregious – US$145bn into global bond funds and US$103bn out of global equities. With bond markets receiving disproportionately high flows over the last 7 years, global equities are under-owned and within global equities, EM is under-owned. In EM, since 2013, both bonds and equities have faced outflows – but equities much more (US$108bn) than bonds (US$20bn)

However, with DM yields looking unlikely to fall further from current levels, the multi-year trend of inflows into bonds looks set to reverse. This in turn should benefit risk assets (such as equities) as **“rotation”** and **“normalization”** of flow of funds takes place (leading to lower equity risk premiums).

Such rotation should benefit EM assets in particular (both bonds and equities). EM assets look extremely attractive from a “carry” perspective with EM fixed income offering a real yield of 2.5% which is comfortably above the sub-zero real rates of DM. Improving current account positions, stabilizing commodities and currencies and high real yields means that EM central banks have scope to cut interest rates further, which is also likely to help EM fixed income. The above in turn is likely to be extremely supportive of EM equity outperformance

Needless to say, there are certain risks to the view. Two risks which immediately come to mind are:

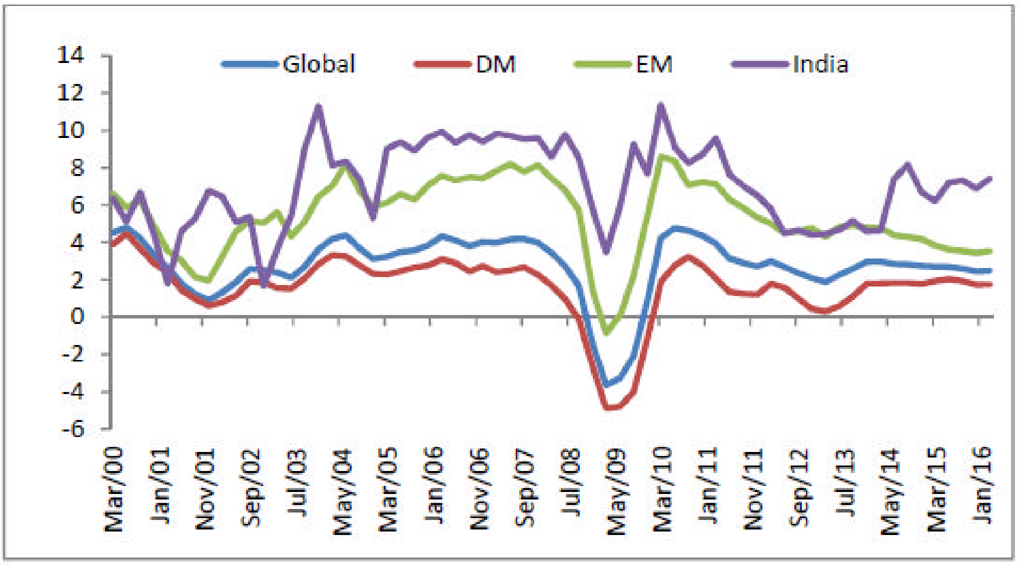
1. **A Stagflationary environment:** The bond market is currently taking a very benign view on inflation. Even the Fed is not showing any urgency to raise rates. Thus, any big surprise in inflation could lead the Fed to raise interest rates much faster than what markets are currently expecting. This in turn is likely to lead to a sharp and abrupt rise in yields which is unlikely to bode well for risk assets
2. **No policy support (both monetary as well as fiscal) resulting in further deterioration in macro fundamentals:** Markets are anticipating continuation of strong monetary policy support as well as introduction of fresh fiscal support. However, the policymakers may choose to defer the stimulus as markets seem to be stable and economies are still growing. Given the structural headwinds, there could be further deterioration of macro (growth and inflation) if the stimulus is delayed or denied. Such a scenario would be negative for assets like equities which do well in a reflationary environment

The case for India in this unusual global context

In this massive search for yield, India is a standout market where its superior macro profile is only improving. There key variables which underscores India's rising attractive in current global context are:

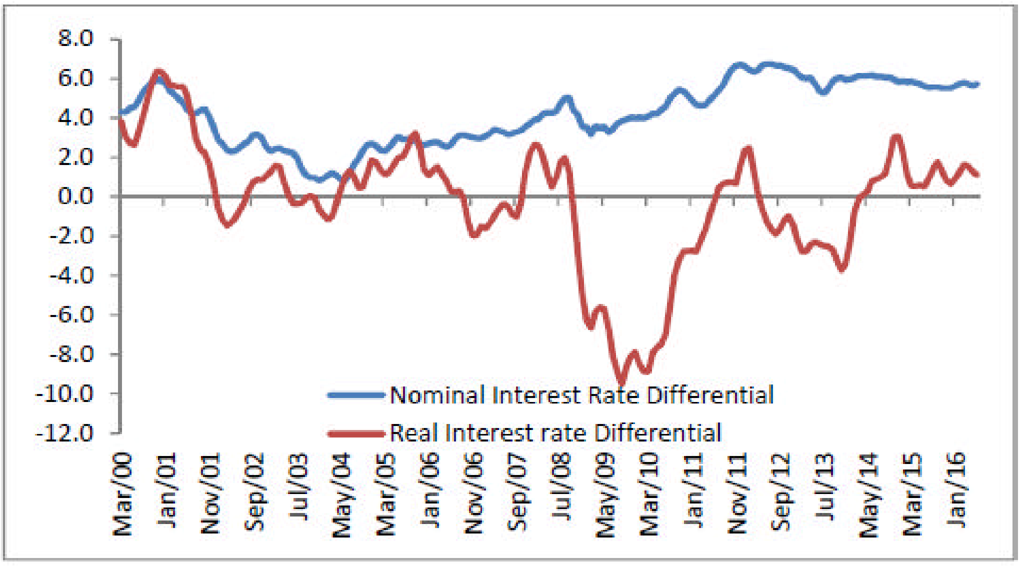
Accelerating growth: Owing to strong consumption recovery, India has become the fastest growing economy of the World. India's growth differential with the rest of the World is significantly rising for the last couple of years. Over the next two years, India's growth premium will further rise.

Chart 1: Real GDP growth (%yoy): India's growth differential with the rest of the World has been rising



Attractive nominal and real yields: The yield differential between India's nominal interest rate differential with the US and other major developed economies are close to highest levels in post Lehman era while real rate differential is also firmly in positive territory.

Chart 2: Substantial differential in rates: Indian 10 year Gsec versus the US 10 year Gsec



Limited leverage: India's debt to GDP has been stable for the last many years. This is in contrast with most of the other economies where leverage has substantially increased. This underscores India's potential ability to increase leverage to achieve higher growth rates without much pressure.

Reforms: In recent times, no country has undertaken the kind of reforms which India has carried out in the last three years. Cleaning up of the system, reduced leakages, resolving supply-side bottlenecks and shift in focus from "populism" to "development". These are structural reforms in the form of the GST, direct benefit transfers, banking sector cleanup, deepening of financial inclusion through Jan-dhan and Aadhar. While many of these reforms may not result in immediate growth but they can certainly catapult India's economic growth into a much higher and sustainable orbit over the medium to long term.

Both absolute and relative attractiveness of India's top down profile is widely acknowledged. The recent poll of over 500 economists across Asia, Europe and the Americas reveal downgrades, or at best no change to growth forecasts for the major economies of the World. India is one of the few exceptions within emerging markets with a stable outlook, and is widely expected to maintain a faster growth rate than others including China over the next few years.

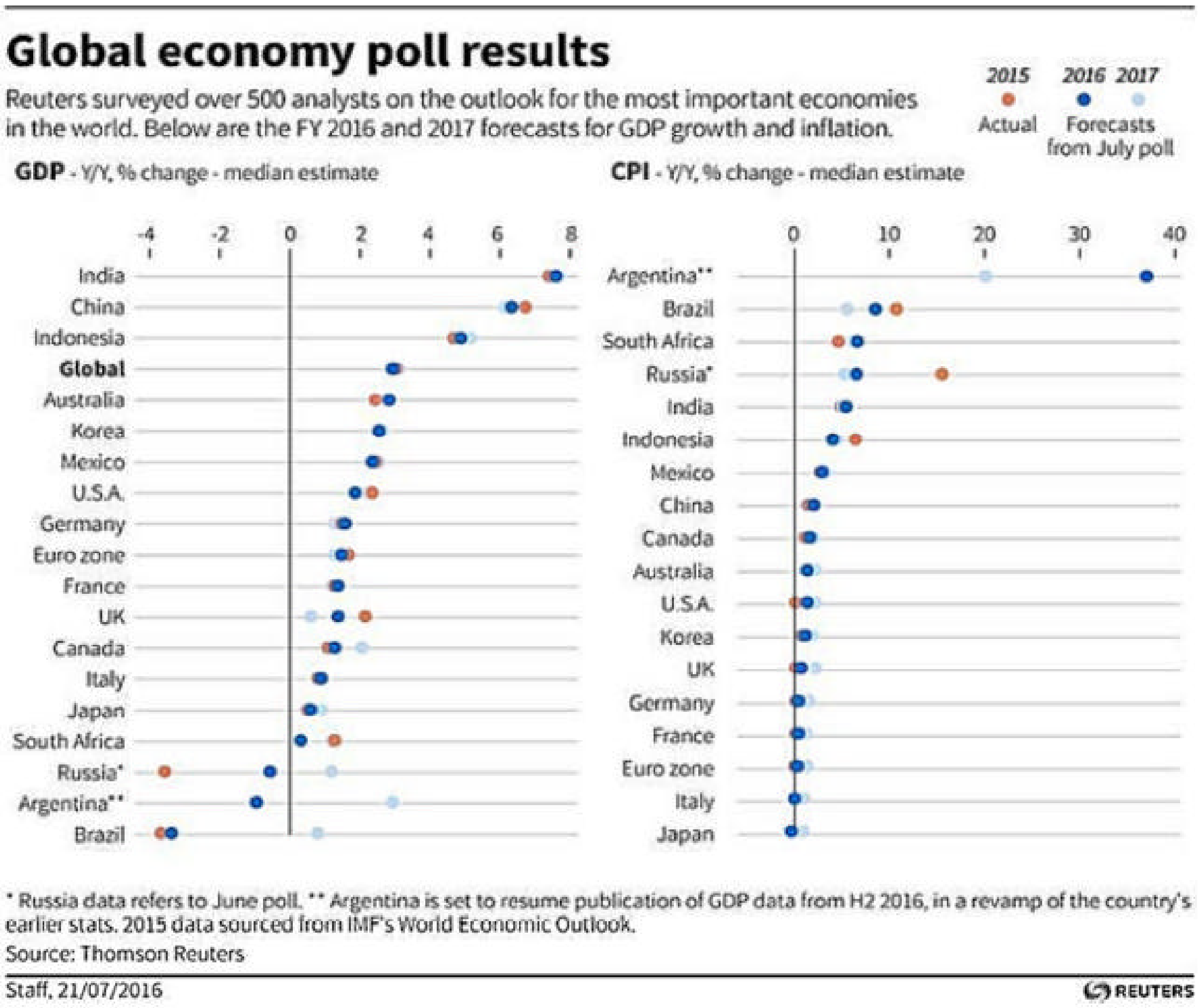


Image: Reuters

What the current global environment means for Indian investors?
India's top down profile continues to improve even in near term as better monsoon, falling local yields and contained crude oil prices all bode very well for India. Admittedly, a lot of these factors are being acknowledged by the markets and therefore reflects in both earnings expectations and valuations. Indian market is trading at 18 times one year forward PE multiple. Although the valuations of the Indian equity market looks high on absolute basis compared to historical averages, it's important to consider what's happening with global valuations. Given the benign global liquidity and rates environment, valuations may remain above average for a substantial period. India has been among the most overweight market as FII inflows in Indian equities has been very strong. Even at the domestic investors' level, there has been a strong shift toward financial assets from physical savings. Therefore, investors should selectively look to invest for medium to long term in preferred themes. The medium term themes are many like in the form new age infrastructure, urbanisation, travel and tourism, etc.

What does current global environment means for Indian Corporates?
In a world where global interest rates have been crushed, Indian Corporates can take significant advantage of the "search for yield" through:

Capital Raising/Restructuring: With global cost of capital currently at its lowest levels, raising of off-shore debt remains at extremely attractive option via two-channels

- Corporates should raise debt through a basket of structurally weak currencies such as GBP (large current account and fiscal deficit), JPY (weak demographics, large debt-to-GDP, shrinking current account), CNY (fears of hard landing, large capital outflows), Euro (political uncertainty and fragikle banking system)
- Rupee denominated offshore debt i.e. "Masala Bonds". For example – HDFC recently became the first Indian corporate to successfully raise rupee-denominated Masala Bond to offshore investors at a cost five basis cheaper than its similar domestic borrowing.

M&A: Global M&A activity has shot-up dramatically in the last two years driven by extremely low cost of debt. In fact, global M&A activity in 2015 stood at US$4.7trn well above the previous 2007 peak levels of US$4.2trn. Thus, low global borrowing costs provide significant opportunity for Indian Corporates to create superior returns through strategic overseas acquisitions

To Summarize, while far from normal, the current global setup offers various opportunities for investors are Corporates alike. Rather than being overly worried about an unprecedented shifts in global financial landscape, one should objectively assess and look to capitalize upon it.