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Can Central Banks Keep Control of Interest Rates?

Inflation-adjusted—or ‘real’—rates remain low, lending support to booming prices for stocks, property and other assets. But some worry that could vanish sooner than markets realize

By Jon Sindreu
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Investors are elated by a booming global economy and the promise of central banks to tighten monetary policy only gradually. The risk in the coming year: that long-term interest rates develop a mind of their own.

So far, those longer-term rates have remained subdued, even as the U.S. Federal Reserve increased short-term rates three times in 2017 and other central banks signal that the era of super-easy monetary policy may soon draw to a close.

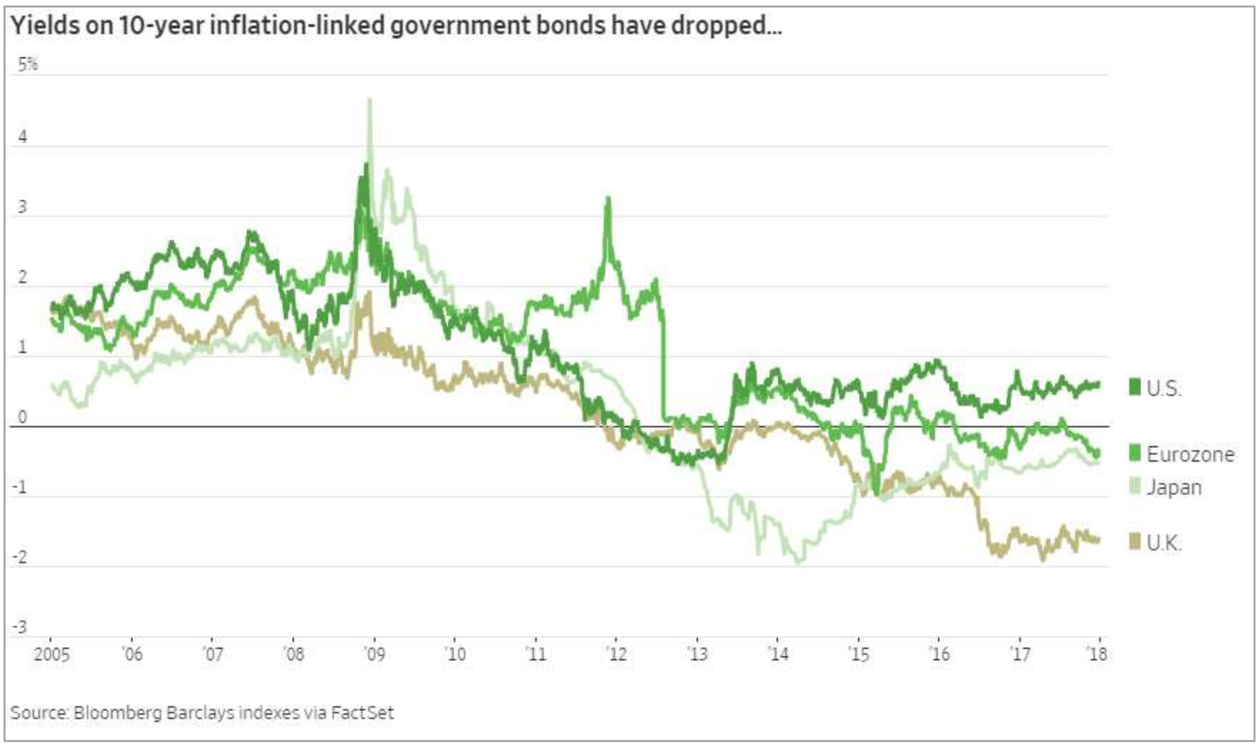
Economists disagree, though, about how much control central banks really exert over longer-term borrowing costs, which are gauged by government-bond yields. So those rates could stop playing along. If longer-term rates suddenly rose, that could throw cold water on stock markets that have been hitting repeated new highs.

The fact longer-term yields—especially “real” ones that are inflation indexed—have stayed low has helped push money into risky assets because investors get little extra purchasing power for holding safer securities.

Subdued real rates, for example, have been a main driver in 2017 of returns in global infrastructure debt and investment-grade corporate debt, according to a new report byBlackRock Inc., the world’s biggest asset manager. Low real rates also boost gold and real estate, analysts say, which don’t pay coupons but don’t lose value when inflation rises.

Complicating matters for investors: whether real rates will behave or not is difficult to predict because “nobody knows exactly what sets interest rates,” said Kevin Gardiner, global investment strategist at Rothschild Wealth Management.

Real rates have often moved in lockstep with central-bank policy—but not always. In the 1970s, runaway inflation pushed real rates down even as the Fed and other central banks increased nominal rates.



Yields on 10-year inflation-linked Treasurys are currently near 0.5%. Before the 2008 financial crisis, they hovered at around 2%. After the Fed unleashed previously unseen amounts of monetary stimulus, they hit a record-low of minus 0.87% in 2013.

For now, that recent experience has convinced many analysts and investors that policy makers have strong control over real rates.

“We are overweight global indexed bonds,” said Paul Rayner, head of government bonds at Royal London Asset Management. “We’ve done a lot of analysis on this, and ultimately the biggest driver of government bond yields still remains central bank activity, even for [inflation-linked bonds].”

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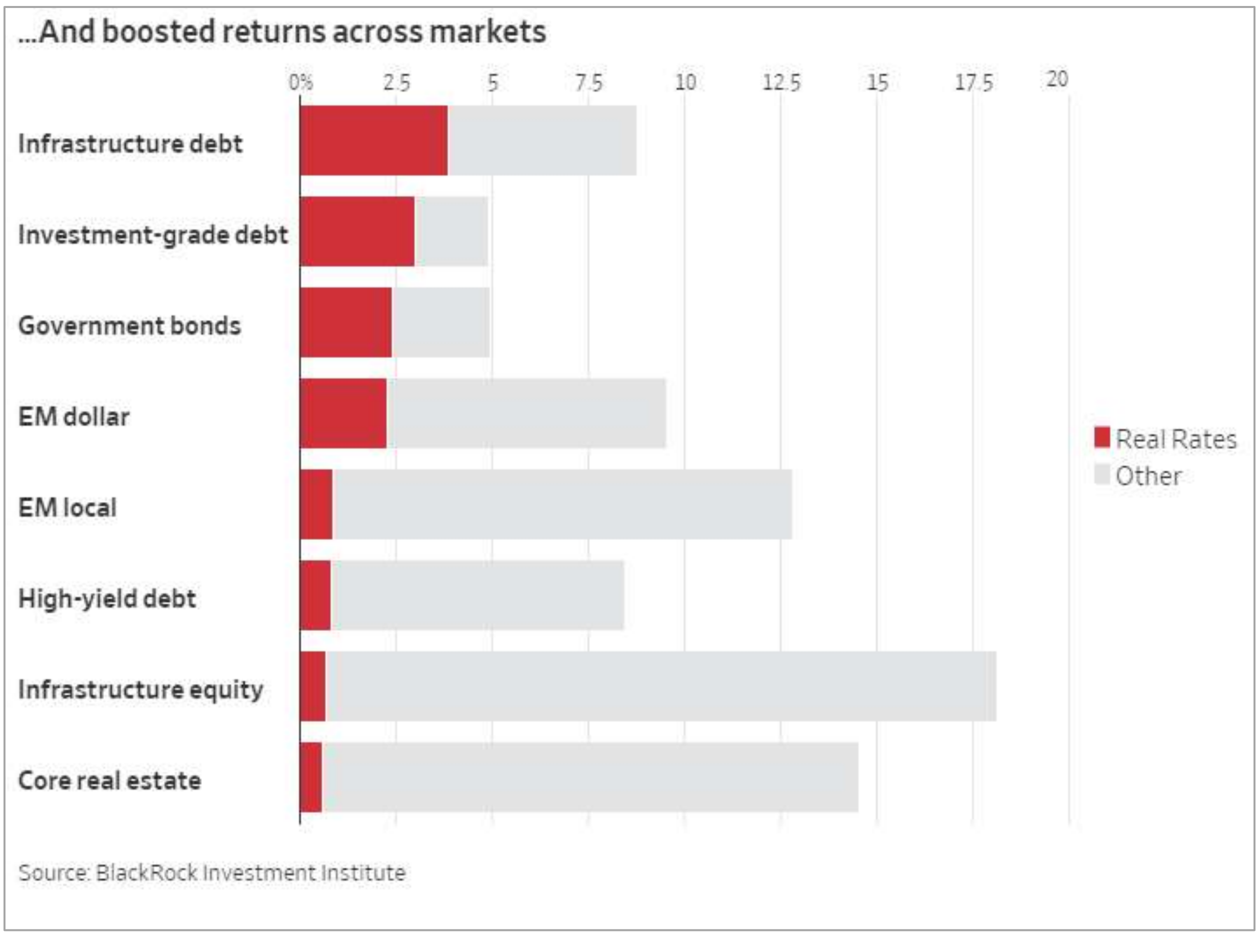
Economic theory says central banks can only influence rates at first, as people ultimately see through their meddling. So unless officials set policy to reflect the economy's long-term economic trends—which is how the Fed's Janet Yellen and Mark Carney at the Bank of England have justified keeping rates low in recent years—inflation or deflation will follow.

According to this view, rates are so low because people are saving a lot and these saved funds can be lent out and used to invest, a copious supply that pulls down the cost of borrowing.



Some money managers and analysts now warn that the tide is about to shift, whether central banks keep policy easy or not. By looking at the share of the population aged between 35 and 64—when people save the most—research firm Gavekal predicts real rates will soon rise as people retire and spend their life savings, eroding gains in stock markets.

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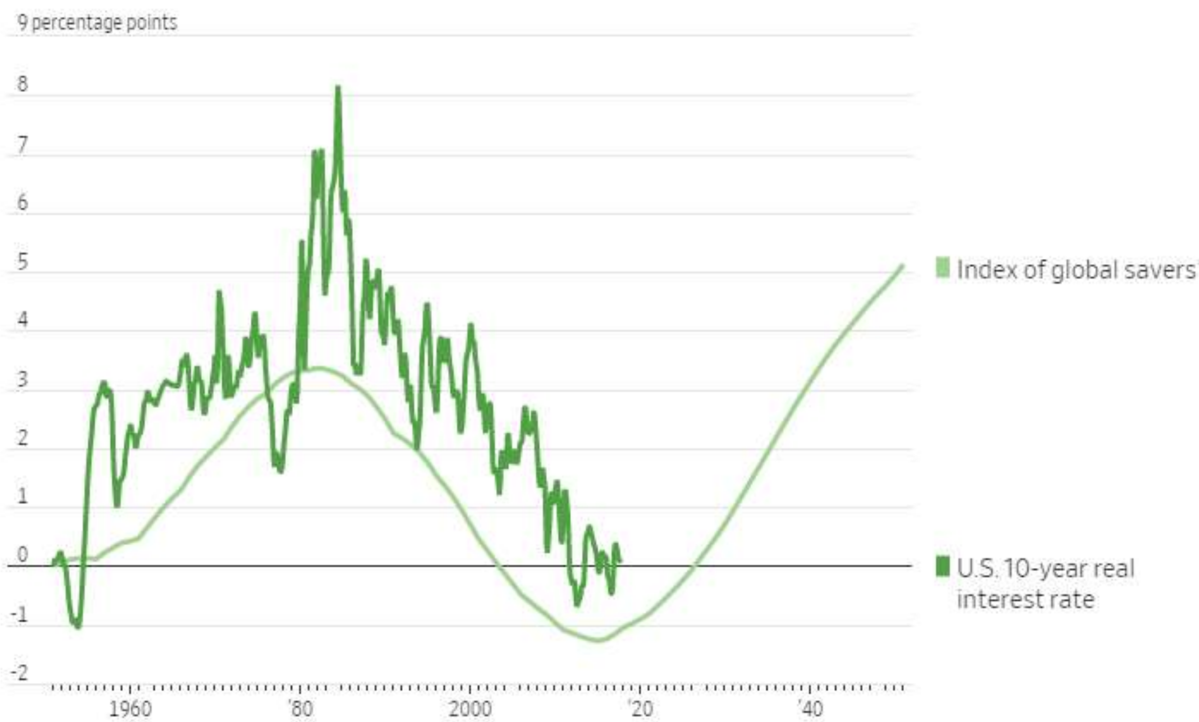
It “could happen tomorrow or 10 years from now, but I’m not counting on the latter,” said Gavekal analyst Will Denyer.

J.P. Morgan Asset Management argues that aging is already starting to push rates higher, meaning that 10-year real yields will be 0.75 percentage point higher over the next 10 years.

Other investors have a different worry: They fear that yields will stay low even if central banks try to tighten policy because they are concerned a recession may be coming. This year, the Fed has nudged up rates three times and yields on long-term government bonds—both nominal and inflation-linked debt—have stayed unchanged or declined, echoing similar issues that then Fed Chairman Alan Greenspan had in 2005.

But some believe a shift in global savings will now push up rates...



NOTE: Change since 1950 *Based on share of the population aged 35 to 64
Source: Gavekal Data

Indeed, the yield curve—the yield gap between short and long-term Treasurys—is now at its flattest since 2007, and many investors underscore that, in the past, this has often preceded an economic slowdown in the U.S.

"Unless the evidence is very compelling that's a false signal, I think the market's going to be nervous," said David Riley, head of credit strategy at BlueBay Asset Management, who is now investing more cautiously.

Still, investors may read too much into what yields say about the economy, said the Bank for International Settlements, a consortium of central banks. In new research looking at 18 countries since 1870, the BIS found no clear link between rates and factors like demographics and productivity—it is mostly central-bank policy that matters.

...While others say central banks control real interest rates

NOTE: Rates of the world's monetary anchor nation (U.K. until 1919, U.S. after)
Source: Bank for International Settlements

Does this mean investors can rest easy because rates won't creep up on them? Not so fast, said Claudio Borio, head of the monetary and economic department at the BIS, because officials may still raise them to contain market optimism. Central banks in Canada, Sweden, Norway and Thailand are thinking along these lines, analysts said.

If central banks control real rates, then it is inflation that has a life of its own—it isn't just a reaction to officials deviating from economic trends—and it could explain why central bankers have failed to stoke it for years. So officials might as well raise rates to quash bubbles instead of “fine-tuning inflation so much,” Mr. Borio said.

Still, Isabelle Mateos y Lago, global macro strategist at BlackRock Investment Institute, thinks investors don’t have to worry about this yet.

“The conversation is moving this way, but I don’t think central bankers have a fully articulated view,” she said.

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