Why low interest rates may last for the rest of your life

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How long can today's absurdly low interest rates last?

How about a generation or more?

The forces that have dragged down rates over the past three decades show no signs of letting up. While nobody can confidently predict what the economy will look like years from now, there are several reasons to brace for the possibility that low rates will be with us for a long, long time to come.

Investors should prepare for the consequences. A low-rate world is one where it hardly pays to own bonds and where market bubbles will be a common occurrence.

But before we get to that, let's look at why low rates may not be just a passing fad.

We can start by disposing of the great central bank myth.

Many people think that today's microscopic borrowing costs are the result of central bank whims. It's common to hear people assert that policy makers could boost rates tomorrow if they just wanted.

This is true only in a very limited sense. Central banks, even the mighty U.S. Federal Reserve, usually exert direct control only over short-term rates. They deal in "nominal" terms – that is to say, rates with inflation included.

Central banks normally have little say in the rates that matter most – the borrowing costs, in after-inflation or "real" terms, for loans that span several years. Those rates are set by debt markets that reflect the independent buying and selling decisions of millions of people.

"The Fed's ability to affect real rates of return, especially longer-term real rates, is transitory and limited," Ben Bernanke, the former Fed chairman, asserts in a recent blog post. "Except in the short run, real interest rates are determined by a wide range of economic factors, including prospects for economic growth – not by the Fed."

Rather than central bank diktat, it was fading inflation that played the biggest role in dragging down nominal interest rates beginning in the early 1980s. Interest rates typically incorporate a buffer to protect lenders from the fact they will be paid back in dollars that will buy less in the future. As inflation faded over the 1980s and 1990s, so did the necessary cushion that lenders demanded.

But inflation has been largely tamed for years now and interest rates are still falling in both nominal and real terms. Economists have concocted many explanations for the continued decline.

Mr. Bernanke, for instance, believes that lower rates reflect a savings glut in Saudi Arabia, China and other developing countries. These countries have excess savings, which they use to buy the bonds of developed countries, especially the United States. This foreign buying pushes up the price of those bonds, which is equivalent to pushing down their yield.

Other researchers expand the search for explanations to include a broader array of factors. In blog posts last year, Lukasz Rachel and Thomas Smith of the Bank of England put forward several reasons for the fall of roughly 4.5 percentage points in global real rates over the past 30 years.

Their list includes slowing global growth, the savings glut in emerging markets, the aging of populations in developed countries and a broad decline in government spending on public goods such as highways and infrastructure.

Their possible explanations also span rising social inequality (which increases savings rates because rich people have more money to save) and the falling price of capital goods (it costs less to build a social-media company today than it did in decades past to build a steel factory).

All these forces combine to increase the pool of available savings and reduce demand for loans, which together combine to drag down interest rates. By stacking the various factors together, Mr. Rachel and Mr. Smith can explain nearly all of the long decline in interest rates.

"We think these secular trends are likely to persist," the two economists write. "This suggests the global neutral rate, which acts as an anchor for individual countries' equilibrium rates in the long term, will remain low, perhaps around 1 per cent."

Not everyone agrees, of course. Other observers argue that today's low rates are a symptom of transient factors, or a reflection of a shortage of "safe assets," which is to say government bonds.

But the market itself seems skeptical of suggestions that rates are headed up any time soon. The Government of Canada 10-year bond pays a skinflint yield of only 1.05 per cent. Yet its 30-year sibling pays out only about 1.65 per cent – a rather small bump to compensate for locking up investors' money for an additional two decades.

The implicit suggestion is that when rates do start to rise in a decade or so, the increase will be very gradual indeed.

In a world where borrowing money is supercheap, it will be easy for investing bubbles to inflate. It will also be a world in which bonds will provide truly disappointing returns.

Unless you're convinced that rates are headed back up soon, it's wise to begin thinking through the repercussions on your own portfolio.