As interest rates rise, beware the Great Doldrums ahead

By Ian McGugan
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Thanks in large part to seven years of rock-bottom interest rates, many investments around the world are shockingly expensive. From Canadian homes to U.S. stocks to European bonds, asset prices teeter at historic highs.

So what comes next? Most of the world's major central bankers – including the Bank of Canada – have delivered unusually uniform messages in recent weeks, pointing to higher rates ahead.

Everything else being equal, a global move to higher rates is likely to start pressing down on asset prices over the coming year, in much the same way as lower rates after the financial crisis provided a powerful push upward.

It's easy to sketch a nightmare scenario in which central bankers jerk on the rate lever too fast, toppling housing markets and stock prices into the ditch and bringing about a new crisis.

More likely, though, is for rates to inch higher in a slow, cautious crawl. Our monetary overlords know the risks of being too aggressive.

They will want to avoid setting off a new emergency even as they attempt to bring rates back to more normal levels nearly a decade after first slashing them.

Exactly how this move to higher rates will work out is open to conjecture. Never before have the world's central banks had to normalize their economies after an extended period of what Andy Haldane, chief economist at the Bank of England, reckons to be the lowest interest rates in 5,000 years.

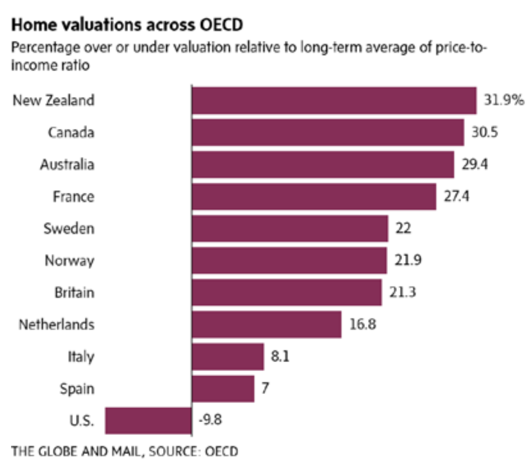
For now, one scenario that many people appear to be willfully ignoring is the prospect of a Great Doldrums – a situation where rates rise but asset prices do little or nothing for several years to come.

For workers, this could be pleasant. Homes would gradually become more affordable; stocks, too. Savings accounts might even start to provide a reasonable return, while higher rates on GICs and bonds would benefit retirees with large fixed-income portfolios.

For other investors, though, the new era could come as an unwelcome jolt. A typical Canadian family, which has seen both its stock portfolio and home value soar in recent years, might have to buckle up for an extended period of much lower returns. That could be painful to people who are counting on big investment gains to finance their golden years.

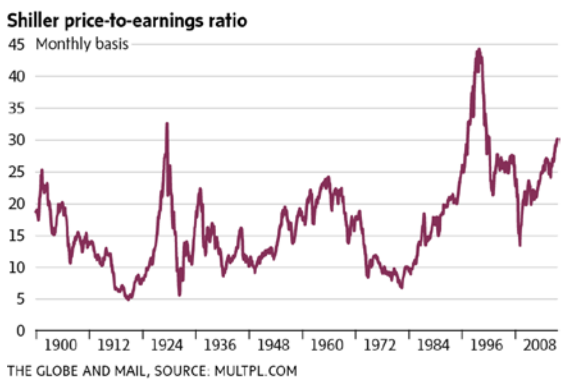
Still, a long lull would be much easier for an economy to handle than a market crash. In fact, an extended pause would be the most painless way to reverse the effects of years of ultralow rates and bring asset prices back into line.

Consider real estate. Based upon the historical relationship between property values and personal incomes, Canadian home prices are overvalued by 30.5 per cent, according to the Organization for Economic Co-operation and Development.



So a decade in which real estate prices flat-lined while incomes grew at 3 per cent a year wouldn't take the market into unfamiliar territory, but simply restore the traditional relationship between home prices and family paycheques.

Similar math holds true for the U.S. stock market, where many valuation measures point to frothiness. The Shiller price-to-earnings ratio, which compares current stock prices to corporate earnings over the preceding 10 years, hovers around 29, far above its historical average of 16.6. A flat decade for stock prices, coupled with steady growth in corporate profits, would go a long way to bringing that distorted ratio back into kilter.



To be sure, a long period of flat asset prices would be an historical anomaly, but if the past decade has taught us anything, it's to be prepared for the unusual.

Nobody in 2007 foresaw an extended period of zero, or even negative, interest rates across many of the world's developed economies.

Right now, a long period of flat asset prices would be the logical result of a standoff between tighter monetary policy and more ebullient growth.

Think of it this way: Central banks' new willingness to raise rates amounts to a vote of confidence in the global economy. For the first time since the financial crisis, all major regions appear to be expanding at a decent clip.

As a result, central banks are eager to dial back the easy-money policies with which they've nursed sick economies back to health. This doesn't have to be disruptive.

If investors conclude that the strengthening global economy is just enough to balance off the drag of tighter monetary policy, then there's no need for asset prices to move much, if at all.

The danger is if central banks miscalculate and raise rates too fast or too slow. Some observers worry that years of low rates following the financial crisis have created financial imbalances across the global economy that can't be easily reversed.

Among other things, near-zero rates have encouraged borrowers around the world to take out mammoth amounts of loans. According to the Institute of International Finance, global debt hit a record $217-trillion (U.S.) in the first quarter of this year, equivalent to 327 per cent of global gross domestic product.

"Financial markets will need to adjust after an exceptionally long period of dependence on ultra-easy monetary conditions," the Bank for International Settlements warned in its annual report this past month. Among the most prominent dangers is that "the global economy is threatened by a global debt overhang."

Another risk is a stock market collapse. GMO, a widely followed money manager in Boston, predicts that large U.S. stocks are set to lose roughly a quarter of their inflation-adjusted value between now and 2024 if markets revert to their historical valuations over the next seven years.

Losses of that magnitude would gut many pension fund assumptions, not to mention many personal portfolios.

Central banks know all of this, and will move cautiously to normalize their economies. "Expect a gradual reversal in yields that will play out glacially over many years," says Tyler

Mordy, of Forstrong Global Asset Management.

Expect, too, that this will not be an entirely smooth operation. Capital Economics notes that seven of the 11 central banks it covers have raised interest rates since 2008, only to subsequently lower them again when growth has disappointed.

The global economy appears to be on a more solid footing this time.

Still, “we suspect that the Bank of Canada will reverse [this week’s] rate hike next year, because we anticipate that the bubble in the country’s property market will burst,” Andrew Kenningham, chief global economist at Capital Economics, writes.

Brace for some bumps ahead.