

## Private Capital Advisers

# Why interest rates could stay low for decades...

Many investors fear the impact of a return to interest rates of 5%, 6% or even 7%pa that were considered normal just a few years ago. They worry about the impact on share and property markets, they worry about locking in fixed rate term deposits and annuities and missing out on the big rate rises to come.

Others are worried about their ability to service borrowings if interest rates move sharply higher.

Yes, interest rates will not be this low for ever, but any rate rises are likely to be modest and temporary. As for 7% cash rates, we are unlikely to see them again for decades.

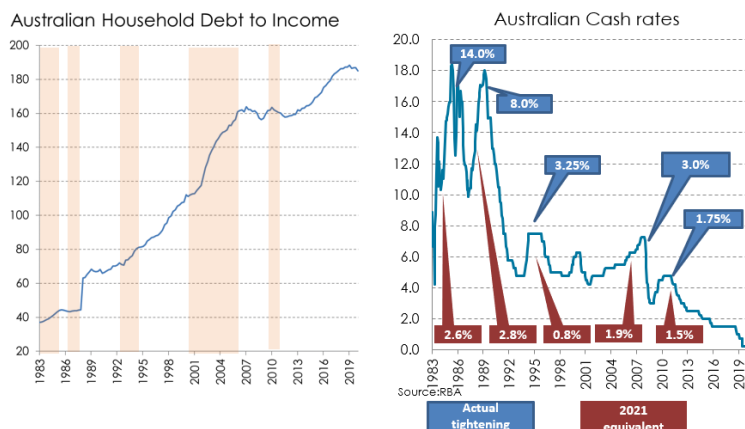
Why?

It is because cash rates are set by the Reserve Bank of Australia (RBA) in order to moderate the growth of the Australian economy and keep inflation in check.

When the Reserve Bank increases interest rates, they hope to slow the economy and thus ease inflationary pressures. The former Governor of the RBA, Glenn Stevens, observed a few years ago, that the impact on the Australian economy of interest rate rises is predominantly felt at the household level rather than at the business level.

This is because those households with mortgages have their spending ability rapidly affected when mortgage interest rates rise while businesses do not normally change their spending plans with every 0.25% change in interest rates.

Critically, the level of mortgage debt in Australia has risen dramatically over the past 30 years. The left-hand side of the chart below shows the level of household mortgage debt as a percentage of household income since 1992 with the bars in the chart showing the five periods where the RBA increased cash rates.



What we see is that household debt rose from 38% at the time of the first rate hike in 1984, to 160% at the time of the most recent increase, to 185% today. What this means is that a 1% interest rate increase today has over four times the impact on household finances that it would have had in 1984.

The right-hand side of the chart on the previous page shows in blue the actual size of the past five rate rises and, given the increase in the level of household debt since that rise, what increase in interest rates would be required today, to have the same effect on the economy.

What we see is that, historically, an equivalent of an 0.8% to 2.5% increase in interest rates has been enough to cool the economy sufficiently to bring inflation under control.

This suggests that if we see an inflation breakout in Australia, a 2.5% increase in cash rates to 2.6% should be more than enough to cool the economy sufficiently to bring inflation back under control. And, given that cash rate of 2.5% will cause considerable stress to households and therefore the economy, interest rates will then probably be eased back to somewhere under 2.0%.

What's more, this is how it will play out until all of those home loans have been significantly paid down. This will probably not be for at least twenty or thirty years. Given these facts, it is very likely that low interest rates have become a permanent feature of the Australian landscape.

Now, many look at the growth in household debt and suggest that it will be a major risk to the economy when interest rates again start to rise. We disagree. The Reserve Bank is completely aware of the level of household debt and has no desire whatsoever to completely crush the economy. As a result, they will be exceptionally careful in raising rates, which is just another reason why we have a high degree of confidence in the idea that interest rates will stay low for decades.

### **What is the impact of sustained lower interest rates on investments?**

Sustained low interest rates are, unfortunately, bad news for investors in term deposits. In the short-term low interest rates are generally a positive for shares and property investments. Most listed companies have borrowings and low interest rates keep those costs low. Low interest rates also enable consumers and other companies to buy more goods, boosting sales,

Finally, and most importantly, when interest rates are low, investors are generally willing to pay more for each dollar of company profits – in other words, low rates help keep share prices high.

However, this is a mixed blessing – paying high prices means that returns from equities will be lower in future years than they have been for the past six or seven years. Nonetheless we should be prepared to stay invested in shares where dividend yields of 4% or more means that returns should comfortably exceed the returns from term deposits.

Low interest rates have a similar impact on property returns. Falling interest rates have been one of the key drivers behind the boom in residential and commercial property prices in recent years. Lower rates means that property investors are willing to pay more for any given property. If interest rates stay low, those gains are unlikely to be reversed. However, higher property prices means lower yields and lower future returns.

So, having an informed view on interest rates is critically important. Expecting that rates will stay low means

that:

- We should not plan on interest rates going back to the old normal levels when contemplating term deposits.
- We should be comfortable with higher than usually valued sharemarkets – for a while at least. But note that the US market is an exception; it does appear overvalued at present and other markets may follow.
- We need to plan for lower than the returns that they may have previously been earned on all types of investments - including property and equities.
- We need to carefully plan our spending levels to ensure that they are sustainable in the lower return environment going ahead.

*This interest rate update has been prepared in conjunction with Farrelly's Investment Strategy without taking into consideration any of your objectives, financial situation or needs. Therefore, you should carefully consider the appropriateness of the information contained in this market update based on your personal circumstances, needs and objectives before acting on it. We strongly recommend you seek personal advice from Private Capital Advisers Pty Ltd and its representatives prior to acting on the information contained in this market update. Personal advice is advice that is given after having considered your relevant objectives, financial situation and needs. If you choose to act on this information without first seeking personal advice, you risk making a decision that may result in a financial loss.*