

Macro Weekly

Heading For Zero — What's Going On?

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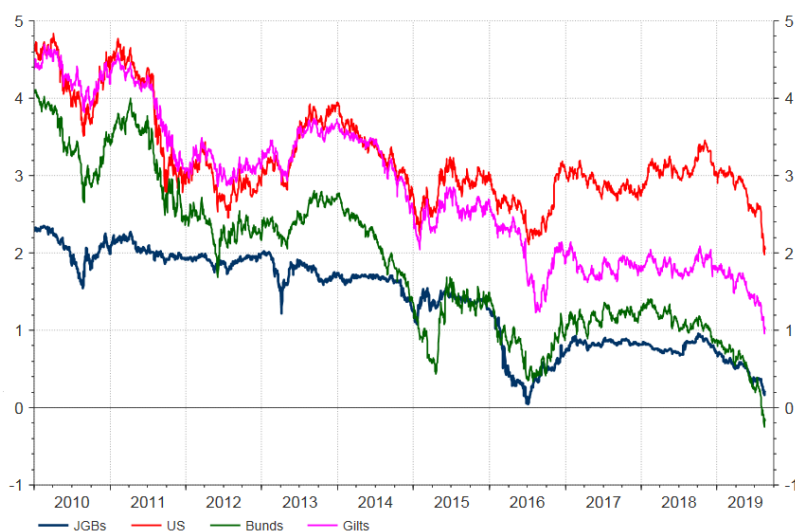
Global central banks have been cutting rates and are signalling more to come. This is a global trend: Australia, India, Thailand, Indonesia, and New Zealand have all cut cash rates recently. The Fed ended a tightening cycle and has cut for the first time in a decade, with more expected (demanded). The ECB has signalled more stimulus is on the way. Japan is also likely to cut rates from an already negative -0.3% and the Peoples' Bank of China may be preparing for its first rate cut in four years.

Are zero or negative rates likely?

Central banks generally cut rates when growth rates have fallen or the economies are already approaching a recession. None of the countries mentioned above fall into this category. The IMF consensus for global growth next year has actually lifted from 3.2% in 2019 to 3.5% in 2020. The policy actions are not to stave off a recession, but to offset deflationary forces.

While recessions are always preceded by inverted yield curves, inverted curves don't always precede a recession. The current structure of debt curves is telling us that monetary policy in the US is too tight. The result is the attraction of capital from around the world as the global reach for yield gathers momentum. This globalisation of financial markets is causing global rates to converge towards the lower bounds.

Figure 1. 30-year government bond yields %



Source: Forsyth Barr analysis, Thompson Reuters DataStream

Primarily because of the positive growth outlook, zero interest rates are not our base case (most likely) scenario. But the prospect is closer than we'd like, with several potential catalysts:

- The US–China trade war deteriorating further
- A messy, uncontrolled Brexit (key date October 31)
- A financial crisis in heavily indebted China or European banks

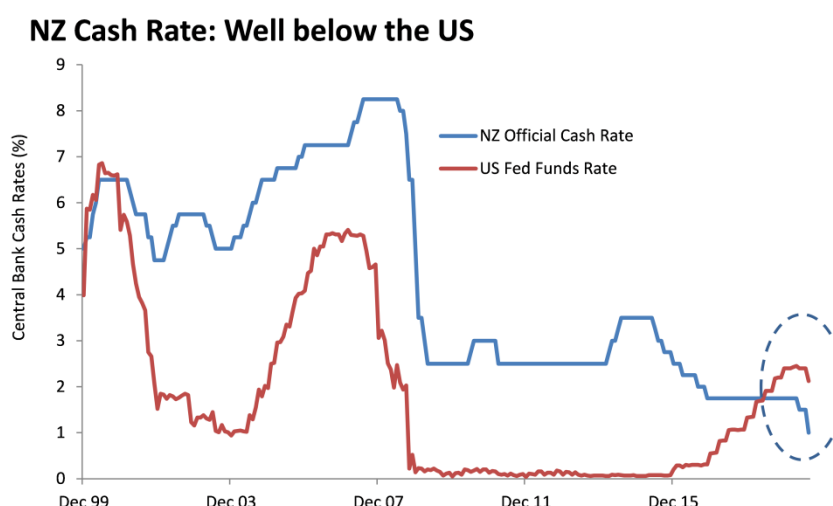
Accordingly, we believe it prudent for investors to at least consider the possibility of zero interest rates sometime over 2020/21.

Asset class implications

Zero interest rates, and the circumstances that drive them, are unambiguously negative for diversified investors. Moreover, the context of the zero interest rate scenarios is critical (e.g. a Brexit driven scenario is very different from a New Zealand specific recession). Nevertheless, we can make some broad asset class observations:

- Negative for risky assets. Whilst dangerous to make sweeping statements, the circumstances that would drive interest rates to zero and below are unlikely to be positive for risk appetite — and therefore a negative for most risky assets including equities.
- Positive for reliable yield. Bonds can make attractive capital gains as interest rates trend to zero. Moreover, bond-like equities (those with a strong, safe yield, such as the NZ listed electricity generators and other utilities) will be relatively attractive even as broad equities may struggle. Importantly, credit quality becomes more critical as interest rates decline.
- Cash loses its crown. Cash is not king if yields head to zero. That said, offshore currencies such as the Yen, Swiss Franc or even US Dollar may benefit as “safe-havens”. Conversely, the NZ Dollar may struggle — particularly if the RBNZ accelerates its easing cycle further. NZ Cash rates are already below the US for the first time in two decades (Figure 1.).

Figure 2. NZ and US official cash rates



Source: Forsyth Barr analysis, Thompson Reuters DataStream

- Positive for property. Hard assets such as property should benefit from zero or negative yields, as the alternative of paying a fee to leave cash in the bank becomes less attractive.
- Alternatives become interesting. In a zero, or even negative, interest rate environment, alternatives such as gold, private equity, or even some absolute return strategies become of interest to us.

Recent tactical asset allocation changes

The Forsyth Barr Investment Committee (FBIC) recently made some adjustments to factor in the possibility of zero interest rates. These are broadly consistent with the preceding discussion and covered in the latest, Investment Perspectives: Issue 49.

SIPO considerations

Forsyth Barr does not recommend sweeping Asset Allocation changes for zero interest rates. As discussed, this is not our central scenario. That said, to be forewarned is to be forearmed. Ensuring the client's current SIPO is fit for purpose in a zero rate environment is a worthwhile exercise. In particular, a wider tactical range on bonds, alongside some scope for holding alternatives (gold et al) may be desirable.

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