Rising Interest Rates and a Stronger USD

The last 30 years have been defined by falling interest rates across the USD curve. Since Volcker defeated inflation in the early 1980's short term rates and long bond yields have tracked lower and lower. Inflation has similarly been trapped in the 3% to 5% range as Greenspan was celebrated for creating a Goldilocks economy, in reference to porridge that was neither too hot nor too cold. Since 1980, the US current account has also trended down into severe deficit until late 2006. During this time, the trade weighted USD has weakened by roughly 50%.

The ability of the US to maintain robust economic growth with low inflation and falling interest rates may be attributed to their outsourcing their manufacturing capacity abroad whether it was to China, Mexico or Japan. The policy would involve exporting US intellectual property and technology to less developed and emerging economies where labour was cheap and diminishing returns were not yet acute. US consumers then imported finished product while exporting USD. The efficacy of this approach would be evidenced by an accumulating balance of trade and current account deficit and a weak USD. The balancing of the current account took the form of a sort of vendor financing in the form of foreign central banks recycling surplus USD by buying US treasuries, keeping USD interest rates low and the US consumer accustomed or addicted to cheap credit. US household's savings rate has steadily declined from 12% in 1981 to 1% in 2005. Inevitably the savings rate has rebounded to around 4.5% today and it appears will need to improve further due to the confluence of a dearth of easy credit, excessive debt levels and impaired collateral prices (read housing prices).

Reversing these imbalances will result in a higher rate of inflation at each level of economic growth as cheap production is less available. Inflation expectations are likely to put upward pressure on long term interest rates.

A shortage of USD internationally will also put upward pressure on rates.

This is independent of the parlous state of government finances. Taking additional account of the fact that US treasuries are effectively PIKs, that total public plus private debt levels (if one includes entitlements) are at some 7 times nominal annual GDP, and the rise of the RMB as a potential additional reserve currency, and the risk of higher interest rates suddenly becomes quite material.

How will the world cope with rising USD interest rates and falling bond prices?

- Interest rates around the world are likely to rise in sympathy since the USD is the de facto reference risk free currency.
- Leveraged trades and businesses will suffer. Banks may face some interesting balance sheet issues. Carry trades will become more viable as curves steepen, although existing positions will face mark to market impact.
- Real estate which is typically highly leveraged will see higher cap rates. In the residential sector, affordability will be affected adversely. Note that many Asian countries are significantly exposed to adjustable rate mortgages. These countries' banks may suffer losses and rising provisions.
- Generally, rising rates are likely to encourage higher savings rates and lower marginal propensities to consume.
- On the positive side, investments will face a higher hurdle rate and there will be less frivolous investment.
- Equity market valuations which are currently highly attractive will seem less so in a higher interest rate environment. The (negative) correlation between interest rates and equity markets is remarkable and rather ominous. *See the chart below*. During the 1960s and 1970s the S&P 500 traded in a band as interest rates rose to combat inflation. While an acutely high inflation scenario is not as likely inflation can be expected to be more elevated and rates higher than currently prevailing.
- The search for yield. The past 3 decades has seen an insatiable thirst for yield that has depressed yields across asset classes and increased yield asset valuations. While on the one hand this has created a problem for pensions seeking to match liabilities, and driven investors into some questionable investments like AAA ABS tranche securities, the dynamics of a rising yield environment are interesting and not so easy to pin down. New investments will see higher yields but current ones, particularly longer

duration assets will face markdowns through lower capitalized valuations.

The above observations are associated with high and rising interest rates. The scenarios we have looked at only consider rising interest rates. They could take some time to get sufficiently high for some of these themes to take hold.