Why we think the central banks will not be able to raise rates for 3-4 years

Frances Donald, Chief Economist and Head of Macroeconomic Strategy, Manulife Investment Management

I have two rate cuts in for the Bank of Canada, I've had them in for about a year, and I had them penciled in for the end of 2020.

I think it might be appropriate to move them a little forward, just because of the commentary that we've been hearing from the Bank of Canada. They seem a little more eager to move in advance. And I still have one rate cut left for the federal reserve, that's probably a low correction rate cut, but my sense is that they're going to want to add a little bit more.

Now, we heard a lot about… in our Econ 101 textbooks, we learned a lot about interest rates rising and falling. Most of us learned about monetary policy. I remember, as a junior, I had to read Bank of Canada statements and write reports of them. Which to me, in retrospect, is sort of funny, because now I have to live react to them on TV sometimes, you know?

But there's one thing we didn't learn about. I was on CNBC in the Fall, and I said something during the interview, and I saw the anchor's face change, and I thought, "Either I'm fired or promoted when I get off of this. And I'm going to have a flurry of emails from people, hopefully from the right people." What I said, and I stand by the call, is that the more important outlook is not whether the Bank of Canada cuts rates by another one or two times, or the fed cuts one more time. The more important call is my call that central banks will not be able to raise rates for at least three to four years.

That's a bold call, right? I didn't get fired. I didn't get fired because I can justify it. I'm going to explain why that is.

In large part, in my view, is because there won't be enough inflation, and there won't be enough growth to justify another hiking cycle for an extended period of time. So, we are going to be in a low-interest rate environment for an extended period of time. I'm talking five to 10 years. Will it go up 25 basis points? Maybe? Down 25 basis points? But this is our new environment. A low-interest rate environment.

Now, you will see on this chart, central banks tried to normalize. They tried to go back to the way things were. What is normal? I don't know. My mom is always telling me she had an 18% mortgage in the 80s, and I don't know how lucky I am, and all that stuff, right?

Normal to the central banks is probably something closer to 3.5 to 4%. That's normally what they'd like to be at. They never got there. In fact, the federal reserve tried to reduce its balance sheet and created a repo market crisis. Their attempt to normalize failed. And it failed in a pretty big way. So now we're heading back downwards, we're heading back down to where it's zero.

Here's why that's problematic. I have 5,000 years of interest rate history. Yeah. I do. Everyone has this. We dive into history books, we are capable of seeing, looking at implied rates of interest. We know that in 3,000 BC, in Mesopotamia, interest rates were around 20%. We know in Rome, in 4AD they were around 4%. There is no period, in 5,000 years of interest rate history, where we have had interest rates this low. I did not learn about this in my textbooks.

And as we get closer and closer to this new territory, we are experiencing things that we never learned about before. One of them is that, as it turns out, zero is not as low as we can go. It turns out we can go into negative interest rates. So here's a chart, it shows you developed… this is only developed, and the yield curve is at the top. If it's red, it's negative, and if it's green, it's positive, right? My team calls this my Christmas tree chart. Only no, it's the global sovereign yield select country negative yielding positive yielding chart.

This is pretty dramatic, right? In the past couple days, this chart might have actually become a little more red, as we saw rates plummet even further. But, again, it's not really where we are now that concerns me, it's how fast we got here. So, here is a chart that shows you the share of total global government bonds that are negative, that kind of dark purple section shows you that. In 2014, 0% of global government bonds were negative yielding. Today, 40%. And it happened very, very quickly.

The number one question that I get, particularly from end clients, but also from advisors, is "Why does this work?" Why would anyone ever buy an investment instrument that they know will lose money? And there's a lot of answers to this, but I think the best explanation is that intuitively, we are more comfortable with negative interest rates than we realize. And I will share a story with you, a secret, actually. I think the gentlemen in the room deserve to know every woman in your life, your mother, your sister or your wife has a secret bank account. The ladies are laughing, they're all like, "why are you telling them?" Okay.

So the secret bank account is for contingency plans. In my case, it's a probability weighted amount of the probability I finally get so tired of them not asking for directions, and the fingernails on the couch, and I just decide that's it, and how much money I think I might need. Like, for example, after I got married, honeymoon, it only had $500 in it, after I had my son, sleepless nights, it had about $12,000 in it. Today, it's okay, it's got about $1,500. Anyways, I'm off the point.

I have a small bank account that I have for contingency plans. It costs me $14 a month to hold it. I don't have a high enough balance. We've all heard of this, right? I have to pay the fees. And yet I do it willingly. And every month, the value of this bank account actually erodes. Why do I do this? Why do I effectively accept the negative interest rate in this account?

A couple reasons. One, I know that it's easily accessible to me. If I decide I need it at 2 a.m. one night, I can have it right away, it's liquid. I like that it's easily transferrable between accounts. That I can put money in it and take money out of it instantaneously. I think it's safer than leaving it under my mattress. I like the fact that I can transfer it between bank accounts, all sorts of reasons. What you'll find is that the reasons people hold negative yielding instruments are very similar to these. They like the fact that these bonds are still liquid. They like the fact that it's safer, in their view, than the banking system, which should tell you something pretty dramatic, right?

Some people believe that rates will go even more negative over time, and this makes it a profitable investment. A whole lot of reasons. But that's not even the real story. The real story is central banks have gotten wise. They know now that you can have negative interest rates, and people will still buy these things. That's pretty dramatic.

So, what we've come to realize is that it's not zero that is the boundary between how low you can go, but there's probably another number below zero. Something we call the effective lower bound. And that number is when you cause chaos in the system. For example, if someone said, "My secret bank account costs $50 a month," I would say, "Forget it, I'll just stay married."

That effective lower bound is what central banks are currently exploring. And that is the true test of this experiment. Most central banks do a lot of academic research and they believe it's somewhere between -1 and -2%, depending on where you are. And as we get closer and closer, then we're testing that theory to a greater degree. This is what probably concerns me most. This is my biggest outlook concern risk, is that we are in uncharted territory. We do not know how low interest rates can go. We have to rely alternatively on new tools over time. We are probably hitting up against the effective lower bound. This is why we hear globally central banks crying out for help from fiscal governments. Please, spend money on certain regions, on certain sectors, on infrastructures, because we can no longer be the tool that supports the global economy.

Do you think that if we cut interest rates again, that it will solve trade tensions? Do you think if we cut interest rates, it will make people have more babies? Do you think it will change the way that we interact with Amazon? No, the problems facing our universe are very different than what they were in the past, and monetary policy is clearly no longer the tool that we need to be relying on. If you want to be really bullish, if you want to argue for curve steepeners and the equity market taking off and potential GDP coming back, you have to argue for government money to come in and start targeting intelligent spending that will help grow our productivity, our research and development over time. This is the way that you can put together a bullish case for the future.

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