The real deal

The Economist

Oct 20th 2012

interest rates
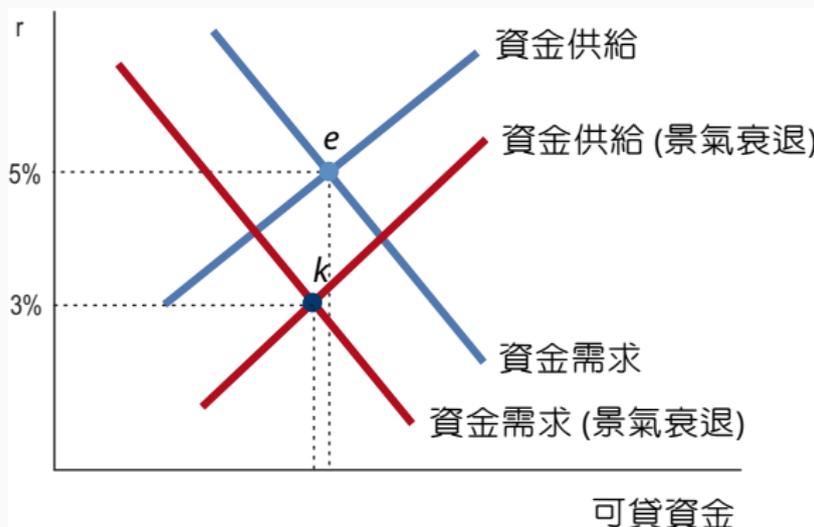
- Interest rates are low across the developed world
- In many countries, they are negative in real (ie, after inflation) terms
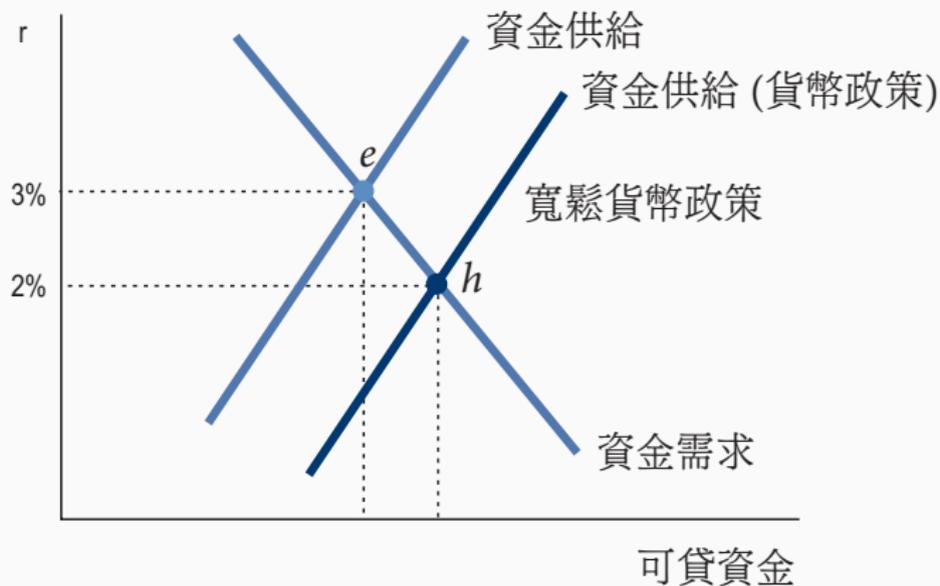
Low or negative real rates

- Interest rates are the price of money, balancing the demand of citizens to save with business's desire to invest

Feeling cautious

- A low real rate may simply be a sign that both consumers and businesses are feeling cautious
- businesses cautious: low investment
- consumer cautious: save more

Monetary policy

- But interest rates are also affected by the actions of the central bank, ie., monetary policy

A weak economy

- Central banks want rates to be low to encourage business investment, and to discourage consumer parsimony (saving)
- In both cases, low rates are associated with a weak economy

Stock market

- The implications of low rates for the stockmarket are therefore double-edged
  - Investors (houselholds) may well be encouraged to shift their money out of cash, and into equities
  - But if low rates are an indication that future economic growth will be weak, … that should discourage investors from buying shares

Two sentiments

- So far in 2012 the stockmarket seems to have been caught between these two sentiments
- At times it has become fretful about the economic outlook; on other occasions it has been buoyed by the prospect of easier monetary policy

In the long run?

- Is it possible to test to see whether low real rates have been associated with good or bad times for shares?
- Barclays Capital Equity-Gilt Study: Treasury-bill yields (interest rates) and real US equity gains (or losses) dating back to 1926

In the long run?

- In the 33 years where real yields (real interest rate) have been negative, the average gain from equities has been 2.3%

- In the years when real yields were positive, the average gain was 6.2%

- Other analyses …
- Some people may think that low real rates will ignite an equity bull market
- But history does not suggest that will be the case