

"It is an endless procession of surprises. The expected rarely occurs and never in the expected manner."

Vernon A. Walters

Why are Interest Rates so Low?

The decline in global interest rates from already historically low levels at the beginning of this year has caught many investors by surprise. At the end of 2013, expectations were for increasing worldwide growth and inflation, which should have resulted in somewhat higher interest rates. Yet, in virtually every important country, rates on government bonds have fallen since January.

This paper will explore both the short and long-term reasons for this condition and consider how investors have been and may continue to respond.

Historical Context

From the 1960s until the financial crisis of 2008-9, US interest rates generally correlated with inflation as shown in Chart 1 below. During recessions, interest rates (particularly short rates) would fall but soon recover. However, six years after rates plunged in 2008, and years after the recovery began in the US and globally, rates have either remained very low or actually decreased further.

Chart 1: Treasury Yields and Inflation

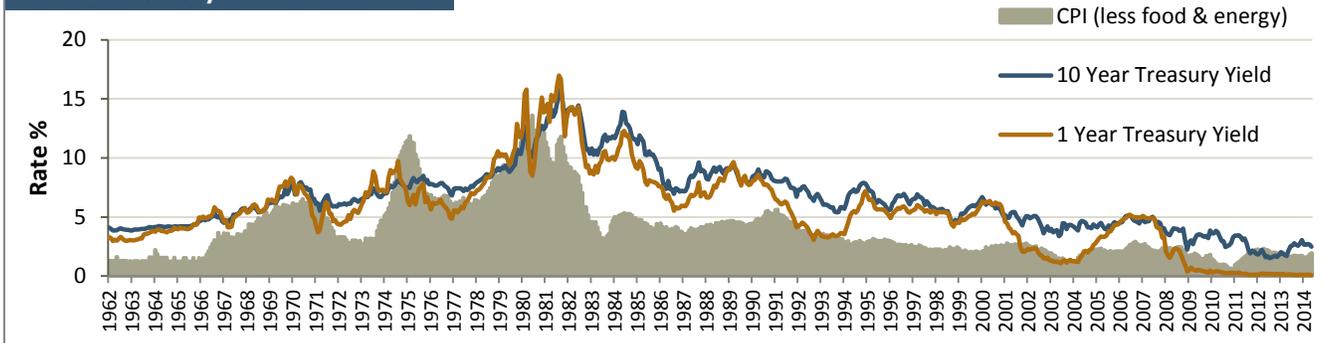
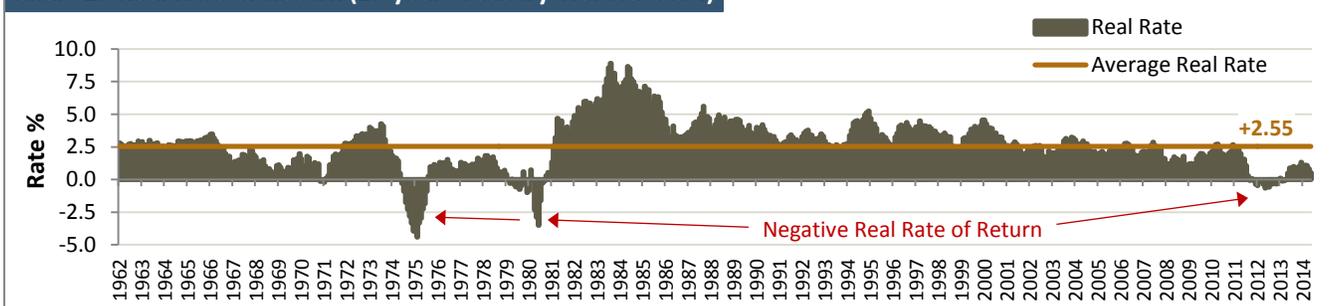


Chart 2 depicts an average real rate of return from bonds of 2.55% over the last 52 years. Returns have varied significantly over this period but rarely gone negative; except during the hyper-inflation period of the mid to late 1970s and the recent experience following the 2008 financial crisis.

Chart 2: Real Rate of Return (10 year Treasury Yield less CPI)



Short-term Influences

- **Disappointing Economic News**
- **Extension of Central Bank Monetary Easing**
- **Supply and Demand for Bonds**

Expectations for real economic growth during 2014 began the year in the 3-4% range. However, unanticipated bad weather across two-thirds of the US caused GDP to contract 2.9% for the first quarter. Weak growth in Europe and Japan also limited borrowing demand, further suppressing bond rates. In addition, all the world's central banks stated their intention of maintaining very easy monetary policies, to encourage growth, through either near-zero short-term rates or, in the case of the European Central Bank, charging clients interest on deposits for the first time in that bank's history.

The relatively low supply of quality bonds coupled with high demand has further depressed rates in recent months. As the government deficit declined in the US, from 9% of GDP in 2009 to just below 3% this fiscal year, the Treasury sold fewer new bonds than in recent history. This slowdown coincided with pension funds and other buyers increasing their demand for high quality bonds. Pension funds have become convinced in the aftermath of the global financial crisis that it is best to match long-term obligations with long-term, fixed price assets, thereby adding to their fixed income portfolio weights.

In the second half of this year, Aureus expects that US growth will improve and that inflation, which was under 1% as recently as last winter, should rise to around 2%. As a result, some of the primary short-term reasons for very low interest rates should dissipate.

Long-term Influences

- **Continuation of Slower Paced Economic Recovery**
- **Investment Decisions in Low Yield Environment**

Studies confirm that a recovery from a financial crisis is much slower and more painful than from a "normal" recession. Within three years from the onset of a typical recession, economic activity has snapped back to pre-recession levels, as both consumers and businesses react positively to government stimuli. Why would a recovery from a full financial crisis be so much longer?

A banking crisis results in a tremendous drop in private debt, followed by a general aversion to debt (e.g. mortgages and business loans). The overall weakness in jobs, personal and corporate income from a subsequent major global recession chokes demand for goods and services, keeping inflation and interest rates low for years. In concert with short term factors such as harsh weather and central bank actions, these macro long-term factors have helped move rates even lower in the first half of 2014.

Very low rates impact decision making of individuals, investors and corporations. Investors are driven by their search for yield to different asset classes and different categories within asset classes. Examples in the equity markets would include the popularity of steady dividend paying stocks, including such sub-groups as REITs and MLPs (vehicles which feature higher than average yields); within fixed income, categories such as "junk" bonds (low quality) and emerging market bonds have attracted increasing attention, despite their relatively high risk. Because of such limited returns on cash, the prices of hard assets such as fine art, real estate, and rare collectibles has skyrocketed.

Corporations borrow more to buy back their own common stock, and they use low cost capital to finance mergers and acquisitions. In fact, merger activity in the first quarter of 2014 surpassed the previous 2007 peak. Comparatively little of this excess cash is plowed back into new plants or increased hiring due to still-limited visible opportunities.

These spending and investment decisions probably will not revert to “normal” until the recovery from the banking crisis is close to complete, which may still take several years.

Aureus has been and will continue to emphasize assets which benefit from low interest rates, including global equities, until it becomes apparent that rates reflect a full recovery from the financial crisis.