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Revenge of real rates

Monetary policy, the macro-economy, and an asset allocation revolution. The thoughts of ***Matthew Addison****, Managing Director, Platinum Capital Management Limited.*

Two events defined financial markets at the end of 2014. First, central bank policy expectations diverged among critical participants, specifically the US, UK, Europe, and Japan. Second, oil accelerated its slide with a push from OPEC's late November meeting, which resulted in no production ceiling cut, and the West Texas Intermediate crude price of oil falling below $70 per barrel, for the first time since 2010, then through $60 and finally $50 per barrel.

With the end of Federal Reserve QE and the recovery in US employment data, FedFunds is now a game of when, not if, rates rise in 2015. Federal spending in the United States has increased for five straight months after being flat for five years. In addition, employment has picked up markedly, adding over 200,000 jobs a month for the majority of 2014, capped off with an impressive 321,000 job gain in November. Increasing FedFunds directly shapes market activity – not only expectations and second-order economic factors, but also flows among financial assets in real-time.

Real Effects on the US Economy – 2015

Oil Price	Unemployment Rate	Core Inflation	Reported Inflation	Consumer Spending	2015 Growth
$80/bbl	5.7%	2.1%	1.1%	2.5%	2.3%
$60/bbl	5.5%	2.0%	0.2%	3.0%	2.7%

Source: IHS Global Insight

The one-way rising US dollar throughout the second half of 2014 came at the cost of Yen and Euro. Japan explicitly reinvigorated the consensus with policy action announced on the last day of October, including postponement of a planned 2015 consumption tax increase. Similarly, ECB intention to initiate monetary stimulus is being over-communicated at every opportunity, specifically because the action itself is slow in coming. The prospect of a carry trade favouring a long holding of the dominant reserve currency at the cost of being short zero-growth markets is an irresistible temptation to traders, institutional asset allocators, and financial institutions alike.

In parallel, as the table below shows, commodity price relief has immediate, as well as medium-term, consequences. The dis-inflationary impact of reduced input costs, especially oil, has a particularly "through the looking glass" effect on asset prices and monetary policy. Lower commodity prices are the principal drivers of reduced inflation expectations for both households and businesses. In the Eurozone, inflation expectations have fallen to a new record low as oil prices have plummeted. The five-year, five-year forward swap rate of inflation has retreated to a new low of less than 1.7%, lower than the depths of the financial crisis.

Lower inflation expectations mean that even without Fed action, REAL interest rates are already going up – short, medium, and long-term in the major industrial economies. The same nominal interest rate – say 3% for 10-year US treasuries – is actually a higher real interest rate (in fact, nearly doubled) as long-term inflation heads from >2% annually to ~1%. This, in turn, both prompts further monetary stimulus and affects the risk/reward balance of asset allocation.

Ultimately, the combination of both the foreign-exchange recalibration from policy rates and commodity relief will shape investment performance in 2015 and create significant new opportunities for the active manager in the year to come.

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