AGF INVESTMENTS: MARKET INSIGHT

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LOWER FOR LONGER:

History tells us that interest rates are likely to stay low.

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In recent years, there has been increasing talk about a bond bubble. Yields have reached the lowest levels that most people have ever experienced. And yet, the history of long-term interest rates tells us that rates are likely to stay low for a protracted period.

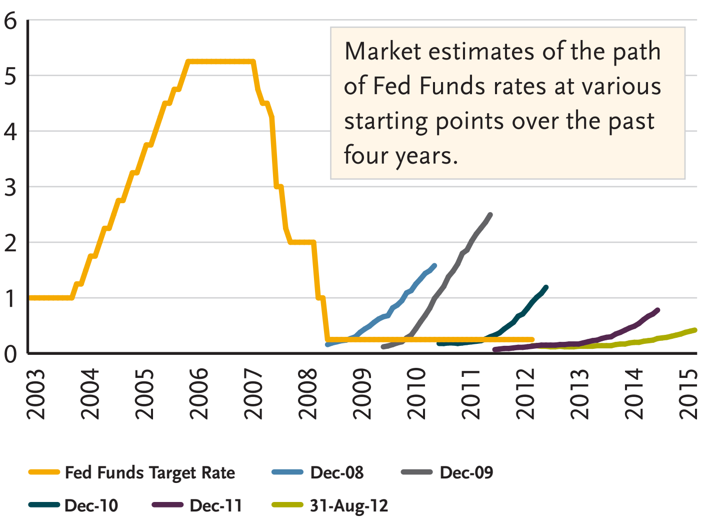
In this paper, we'll examine what's happened in previous financial crises, and what those episodes may portend for the current cycle.

Fed on hold

The only reason many investors believe interest rates will not rise for the next few years is because U.S. Federal Reserve Board (the Fed) chairman Ben Bernanke has explicitly stated that the Fed is on hold through mid-2015. Indeed, the majority believe that interest rates will start to rise as soon as this period expires, as indicated by the Fed Funds Futures market (see Figure 1).

Figure 1: Wrongly anticipating rate hikes

Ever since the financial crisis of 2008, the market has consistently been premature in anticipating rate hikes.



Source: Acuity Investment Management Inc. Bloomberg, U.S. Federal Reserve

Yields stay low post-crisis

Unfortunately, forecasters who predict rising rates in the next few years are likely to continue being disappointed. The history of post-financial crisis interest rates looks substantially different than these relatively optimistic prognostications (see Figure 2).

The most recent example is Japan, which has been mired in a virtually zero interest-rate environment for nearly two decades. Some observers may object that there are differences between Japan's challenges and those of the United States. While we would concur, there are some key similarities, including a collapse in the real estate market, which is the bedrock of personal wealth.

The best-known financial crisis of the past century, the Great Depression, also shows a similar outcome. Again, while there are numerous distinctions versus the current situation, there are also many similarities.

A third major crisis took place in the United States in the 1870s. In both prior American instances, long-term bond yields persisted in a sub-3% range for approximately 20 to 30 years, far more than the four years we have experienced so far, or the seven years that the consensus is expecting. In fact, these are the only periods in the last 200 years during which yields have been below 3%, so the yields we are experiencing are indicative of an abnormal period of prolonged disinflationary economic activity following a financial crisis.

Figure 2: Duration of Low Yields Post financial crisis

Boom periods of excessive investment followed by prolonged disinflationary workout

- **Railway boom (1860s)** → deflationary clean-up (1870s-1890s)
- **Auto/electricity/telephone boom (1920s)** → deflationary clean-up (1930s-1950s)
- **PC/Internet/wireless boom (1990s)** → deflationary clean-up (2000s-2010s)

Location of Crisis	Panic Year (Year 1)	# Years Post-Crisis to Lowest Yield Level	# Years until Yields Rose above 3%	Change in Yields from Year 4 to Year 14
United States	1873	17	32	-130
United States	1929	13	28	-130
Japan	1989	14	n/a	-380

Sources: Acuity Investment Management Inc. Hoisington Asset Management. Ned Davis Research: Prior to 1919 – *A History of Interest Rates* by Sidney Homer & Richard Sylla (Annual Average); From 1919 to Present – U.S. Federal Reserve (Annual Close). Bank of Japan.

Record debt this cycle

So why should bond yields remain so low this cycle? Quite simply, the reason is record debt levels. This unprecedented situation has had several undesirable consequences.

First, monetary policy is not as effective as it has typically been. Even with aggregate interest rate cuts of 5%, plus approximately $3 trillion of delivered and announced quantitative easing, plus available backstop facilities during the crisis totaling many trillion dollars more, plus fiscal stimulus (extra government spending) in the trillion dollar range, the United States has only been able to achieve an anemic economic recovery by historical standards. Indeed, unemployment, one of two key variables the Fed targets, remains far higher than broadly accepted estimates of full employment.

Monetary policy has lost much of its efficacy because it is no longer able to stimulate lending. Banks have tightened lending standards in the past few years following prior periods of excess and are unlikely to relax those parameters much in the face of significantly increasing regulation. In addition, consumers are reluctant to borrow after having binged on debt to record levels and seen their wealth decimated.

As a result, the typical post-recession credit expansion has been absent. In fact, quite the contrary: the west is still in the early stages of deleveraging. Until debt is reduced to a more manageable level, we are unlikely to witness a major credit-led boom.

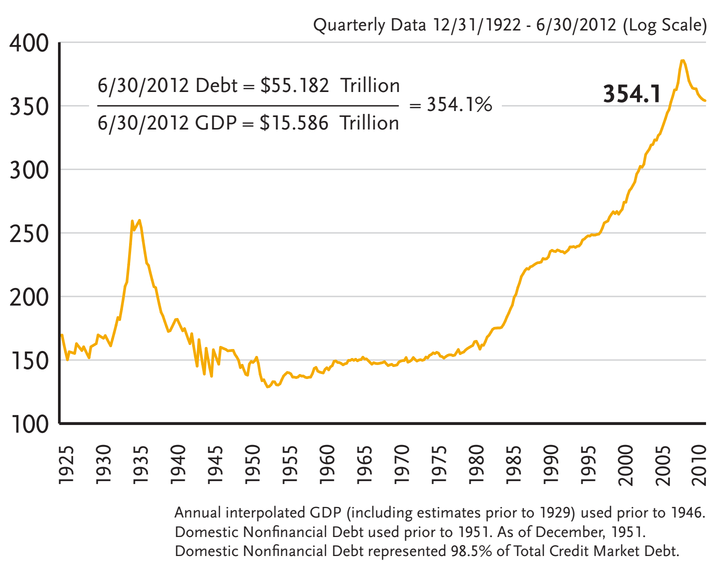
This point leads to the second negative consequence. Credit has historically provided a tailwind to economic growth. In a deleveraging world, however, the reduction in credit should continue to be a headwind, as it has been for the past few years. Interest rates tend to stay low during low growth periods, as rates are generally correlated with growth.

Finally, quantitative easing may have unintended consequences in that it may actually prolong the problem of assimilating high debt levels, since it delays the inevitable. Indeed, low rates actually discourage saving. We cannot move forward until the core debt problem is dealt with, not merely papered over by treating the symptoms. (Note that we are not suggesting that the Fed's innovative actions were ill-advised – there is little doubt that they prevented a far more severe meltdown than the United States actually experienced. However, since the moves of 2008-2009, successive policies have been much less desirable and effective for the reasons discussed above.)

Figure 3: Unprecedented debt levels

The western world (including the United States, shown here) is indebted to a degree never before witnessed, when combining personal, corporate and government debt.

Total Credit Market Debt as a % of GDP



Source: Ned Davis Research, Inc., U.S. Department of Commerce as of June 30, 2012.

Where do we go from here?

We can draw several conclusions from the evidence of these past cycles.

INTEREST RATES TO STAY LOW

First, interest rates are likely to stay lower than most anticipate, for longer than they expect. We are not necessarily insinuating that it will take a full 20-30 years for rates to begin to normalize. All that is needed is for rates to stay low for longer than most expect for this viewpoint to produce out-of-consensus investment implications.

The only caveat to this scenario is the U.S.'s entitlement programs (health care and social security). If investors become worried about the U.S.'s solvency because of the massive $60 trillion of these unfunded liabilities, yields could rise meaningfully. However, we believe that the U.S. dollar's status as the world's safe haven currency, coupled with a gradual realization of the need to address the entitlement issue, should alleviate solvency concerns.

Nonetheless, that does not mean that we are strongly bullish on government bonds. While yields may remain in a low range, and still have room to decline modestly further based on the ultimate lows achieved during each of these three historical cycles, the fact is that yields of 1-2% just do not offer any sort of meaningful wealth-building characteristics, especially after taxes (if applicable) and inflation (modest as it is). So what is an investor to do?

SEEK HIGHER YIELDS

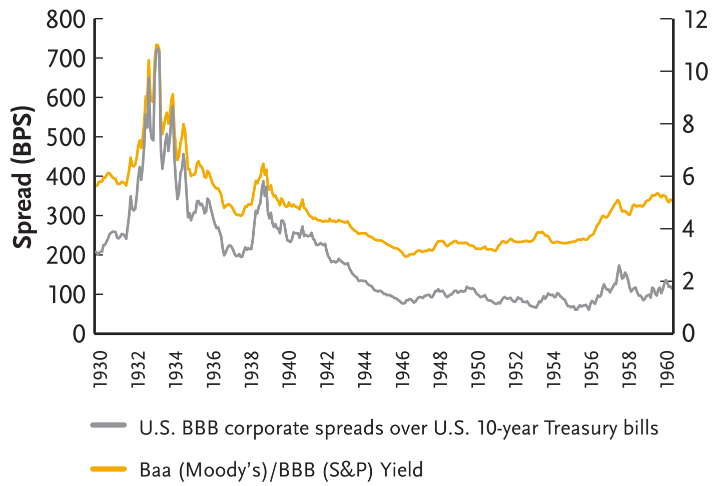
This question leads to the second conclusion, which we have been advocating for years – seek credit with substantially higher yields that more than compensate for slightly higher risk profiles. Even after the strong run of recent years, many investment-grade corporate bonds offer 3-4% yields, more than twice those of governments.

In addition, high-yield bonds sport spreads of nearly 600 basis points (bps), much wider than historical norms of approximately 450 bps. While all-in yields of less than 7% are at historic lows since the advent of this asset class in the 1980s due to the persistent decline in rates over the last 30 years, that still represents a seven-fold increase over government bond yields of comparable duration. These investments clearly do not come without risk, but we believe they are still attractive with higher than normal spreads, as long as the United States avoids recession (defaults tend to arise predominantly during recessions).

Figure 4: Viable alternative in a low-yield environment

BBB bonds still have spreads of nearly 250 bps (2.5%) over governments, resulting in nearly 4% yields, while suffering negligible default rates historically. During the last post-crisis cycle, in the 1940s-1950s, BBB spreads declined to less than 100 bps, and all-in yields to 3%.

US BBB(S&P)/Baa (Moody's) Corporate Debt



Source: Acuity Investment Management Inc. Desjardins, U.S. Federal Reserve Board

DON'T DISCOUNT EQUITIES

Finally, this sober economic outlook does not preclude the possibility of an improving stock market. Equities have often turned higher before the end of a period of economic malaise, and have also experienced substantial rallies during secular bear markets, such as the cycle we are currently in.

While we believe the next several years may remain challenging for equities, we are likely much closer to the end of the bear than the beginning. During the 1930s and '40s, the final significant bottom occurred in 1942, after which stocks gradually rose through the remainder of the decade (despite the biggest war in history), and surged higher during the '50s, even as interest rates stayed low.

The Final Word

Again, each cycle has both similarities to and differences with the past, but investors should not assume that sub-par economic growth will inevitably produce equity bear markets. What it is likely to produce is low interest rates for a prolonged period.

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