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Interest rate rises will return

By Tony Jackson
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The recent jump in government bond yields may or may not prove durable, but it prompts a wider question. Interest rates have been falling globally for 30 years. Sooner or later, they are going to start rising again. How might this affect business and investment behaviour?

That would depend on what caused it: a revival of inflation, say, or a shift in the balance between savings and investment. The latter is proposed in a paper from McKinsey, which argues that over the next two decades investment demand from China and other big emerging economies will outstrip global savings.

We need not dwell on the details of this, since it is not in the nature of 20-year economic scenarios to be strictly accurate. It serves rather as a handy framework for thinking through the consequences.

Let us begin by setting the inflation/deflation debate on one side, and taking instead the McKinsey hypothesis that interest rates will rise in real terms. What would that mean for investment strategy?

McKinsey argues it would be good for bonds and bad for equities. This seems paradoxical, since it would mean both asset classes behaving in the same way when rates rose as when they fell.

Still, the argument is a long-term one. The attraction of bonds in the new world, it is claimed, would simply be their superior yield. But getting there would involve a steep fall in the value of existing bonds. If that dragged on for long enough, investors might form the same settled prejudice against bonds as they have now against equities.

The case against equities is obvious enough. Higher interest rates mean higher discount rates, so the present value of future corporate cash flows is lower.

But again, the reality might be more complex. McKinsey envisages colossal expenditure on infrastructure and real estate, with China needing the equivalent of a New York City every two years and India needing a Chicago a year.

If true, this would mean that companies able to exploit the phenomenon would come to dominate the exchanges. Other companies would fade by comparison; but once the adjustment was complete, equity indices might reflect a wave of growth.

What about commodities? Caution is called for. The China story is scarcely new, even if McKinsey draws novel inferences from it. For commodities, the story ought to be in the price.

Over time, the production and use of commodities become more efficient – in developing nations especially. As Dylan Grice of Société Générale puts it, when you buy commodities you are selling human ingenuity.

That said, let us move to a broader and perhaps more interesting question: how higher rates would affect the behaviour of corporations. Three decades of falling rates, after all, have produced a set of habits and assumptions which would need re-examination.

Companies in capital-intensive industries would be under extra pressure to raise their capital productivity – that is, output per dollar invested. Those with positive cash flows, such as food retailers, would make hay on the operational side, while being constrained in their expansion plans.

And as McKinsey plausibly argues, balance sheet structures would change. The remarkable global rise in short-term debt since the early 1990s would have to reverse. Frequent refinancing represents a risk which only makes sense if the cost of debt is persistently falling.

Indeed, there would more general pressure to replace debt with equity. Several things might follow.

In a world short of savings, companies would redouble their efforts to form long-term relationships with sovereign wealth funds, pension funds and the like. This, in turn, might have interesting effects on governance.

It might also make boards less keen on performance measures which push them towards high debt levels, such as earnings per share. Governments might finally reconsider their pro-leverage bias in granting tax breaks on debt interest.

What about the banks? As McKinsey says, the prospect of rising global investment demand relative to savings means a steep yield curve. That makes conventional retail and commercial banking more attractive, since it raises the profits on maturity transformation – that is, borrowing short and lending long.

And any investment banking activity requiring capital would become even less popular, particularly when combined with Basel III capital requirements. And private equity and hedge funds would be further starved of leverage.

When might all this start to happen? About five years out, McKinsey guesses, assuming inflation or government profligacy will not set the ball rolling early. But short of global deflation or economic collapse, it is coming, sure as Christmas.

tony.jackson@ft.com