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Asset Allocation

THE 'SUPRASECULAR' DECLINE IN INTEREST RATES

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It's rarely we come across an eight-century trend. But when looking at long-term real interest rates, we see a bumpy but steady decline in rates since the 14th century. This provides lessons that can help us understand today's volatile markets.

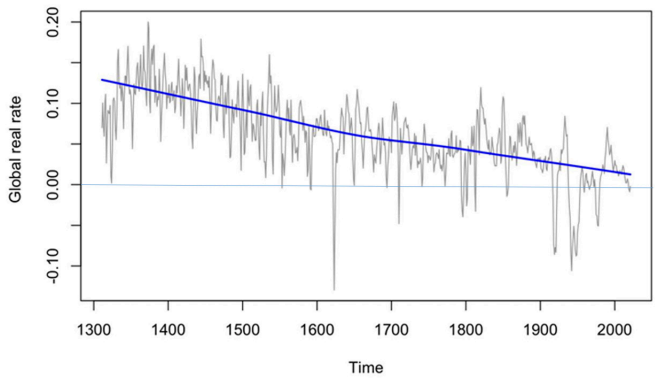
But first, some definitions. *Inflation* is the general upward movement in the prices of goods and services. Inflation weakens the purchasing power of your money because you can't buy as much as you did before.

Real and *nominal interest rates* are used to distinguish rates that do and don't consider inflation. A nominal interest rate is what you'll most commonly hear quoted. For example, the interest you receive on your bank account, term deposits or bonds do not consider inflation. But a real interest rate has been adjusted for inflation. In many countries you can buy "real return" bonds, which pay you an interest rate linked to inflation. The nominal rate is the real interest rate plus expected inflation. And the real interest rate is the nominal rate minus inflation.

Understanding real rates is especially important when inflation rates are high or changing rapidly. For example, in the 1970s a 10%+ nominal interest on deposits at the bank might have sounded attractive. But during the '70s, inflation was also high – even higher than 10% – so real interest rates were often negative. Investors might have thought they were getting a good deal. But they were actually losing purchasing power, even after receiving 10% interest.

In contrast, in the 1990s nominal rates were relatively low, but inflation was even lower. So, real interest rates were positive – meaning investors in deposits or bonds were gaining purchasing power.

Paul Schmelzing, a postdoctoral researcher at Yale and visiting researcher at the Bank of England, wrote a paper in 2020 on this *suprasecular* (beyond long-term) trend on real interest rates. Schmelzing updated his paper in 2022, along with Kenneth Rogoff and Barbara Rossi. They noted that real rates can change dramatically in the short term, but there has been a noticeable decline in rates over time. Schmelzing, Rogoff and Rossi calculated this decline to be 0.013% per year for the last seven centuries.



Source: Long-Run Trends in Long-Maturity Real Rates 1311-2021, Kenneth S. Rogoff, Barbara Rossi, Paul Schmelzing, Working Paper 30475.

Many theories try to explain the downward trend in rates. Some, usually focusing only on the decline in the past 10-20 years, revolve around declining productivity and its dampening effect on economic growth. The theory here is that slow growth goes hand in hand with low real rates. Another theory, favoured by Antti Ilmanen in his excellent book *Investing Amid Low Expected Returns*, focuses on the imbalance between savings supply and investment demand. The "savings glut" hypothesis points to the savings accumulations in China and other emerging economies this century, combined with those related to aging demographics and the growing need for pension savings. This theory seems more consistent with the longer-term evidence, as rates have fallen while global growth has increased sharply since the Industrial Revolution.

Also, improvements in the overall standard of living increase the proportion of people with the ability to save. When the general standard of living is low, it's hard for people to save. Those relatively few savers can command a higher interest rate than when many people save.

This research provides some important perspective on the oft-heard debate about when rates will return to "normal," as we were all hearing until last year. One issue is, what do you mean by normal? If you grew up in the 1960s and '70s during the oil shocks, you may recall how rates kept surprising people by going up more than expected. But since the '80s, and especially from 2008 until recently, rates were surprising us in the opposite direction. The consensus might be that these two trends cancel each other out, so we get something like 2-4% real rates. But based on the long-term evidence, real rates show a strong tendency to fall over time.

What does this mean for investors? Extrapolating trends can be dangerous, even 800-year-old ones. But if we do extrapolate, in a few decades we might see not only zero interest rates, but even negative interest rates in advanced economies like the U.S. This doesn't mean real rates will eventually become extremely negative with no bottom. There might be a natural lower limit to how low real rates can go. After all, who wants to lend money only to be paid back less? Maybe just don't lend it in the first place – essentially keeping rates only slightly negative.

After dipping below zero for a couple of years after Covid, real rates are now back up to their long-term trend line of just over 2%. This increase has pressured borrowers, but has been very welcomed by savers. While the long-term trend is down, we've also seen that real rates are volatile and in the short term could easily go up or down. In these circumstances, diversifying your fixed income across maturities – holding short, intermediate and longer-term fixed incomes – is more important than ever. So is matching those maturities to your needs as determined by your personal financial plan.

It's always tempting to make predictions and bets based on our own beliefs and experiences. But as always, we feel the safest and most profitable approach is to focus on your goals – and on organizing, protecting and growing your wealth through proper planning and a disciplined rules-based approach to investing.

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