

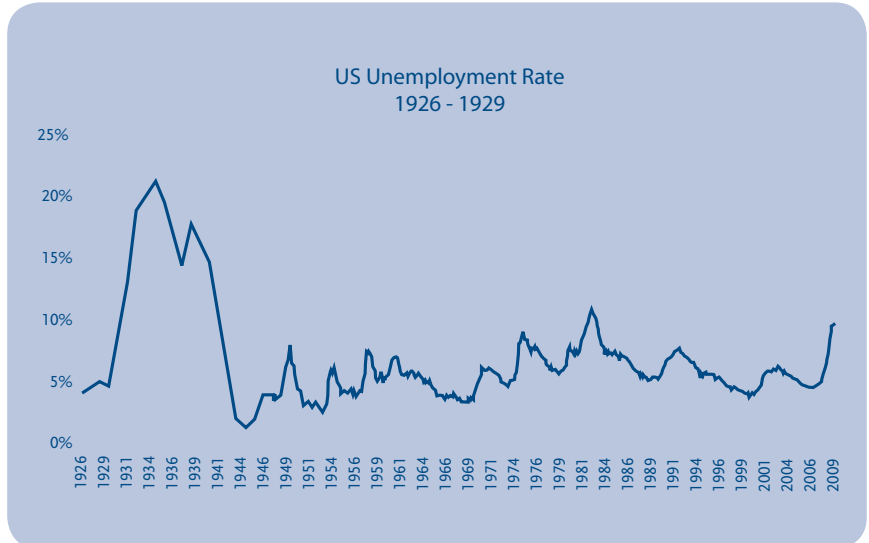
The Future of Interest Rates

Interest Rates May Stay Low For Longer Than You Think

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Although many analysts fear the inflationary consequences of the massive money supply created by the U.S. Federal Reserve, deflation remains a more immediate threat. With the current U.S. unemployment rate over 10%, the slack in the labour market continues at levels not seen since the Great Depression and the recession of 1981-82. The severity of the recent employment loss is evidenced in the following chart illustrating the U.S. unemployment rate from 1926 through August 2009.



U.S. Job growth will likely be muted once it begins. With companies focused on productivity and bottom line performance, a replay of the so-called “jobless recoveries” that occurred after the mild recessions of the early 1990’s and 2000’s is almost certain. The unemployment rate is expected to decline very slowly. Hence, a wage increase spiral, one of the causes of inflation in the 1970’s, is not in the cards.

The other potential cause of inflation - too much money chasing too few goods – is also not a risk in the near term. In fact, the opposite is true; today there is too much production capacity facing too little demand. As shown in the following chart, the manufacturing utilization rate in the U.S. plummeted to 65% in May 2009. This is the lowest level since monthly rates began being recorded in 1948.

In fact, at present there is simply “too much” available whether it is airlines, newspapers, automotive plants, houses, apartments, TV stations, offices, restaurants or retail outlets. Job openings and easy credit are the rarities.

Unfortunately, a full recovery from a credit bubble collapse takes years not months. In a typical business cycle, monetary easing eventually triggers a powerful recovery that is first powered by inventory rebuilding. Quickly-rising employment and income then drives consumption-led growth. In the aftermath of a financial meltdown, too much debt, weak job creation and limited business investment undercut demand growth in the face of excessive supply. The rate of price increases is therefore more likely to fall than rise. We could even face outright price declines as occurred in Japan over the past two decades and worldwide in the 1930’s.

Recoveries from a credit bubble collapse are fragile and easily derailed. For example, Japan’s recovery from the bust of the early 1990’s was choked off in part by the Asian crises of 1997-98. Also, central bankers and governments must adroitly remove their monetary and fiscal stimuli at some point so as to avoid an eventual inflationary surge and repair government balance sheets. In 1937, concerned about renewed inflation and swelling government deficits, the Federal Reserve and the Roosevelt administration increased bank reserve requirements and moved to cut spending. These actions

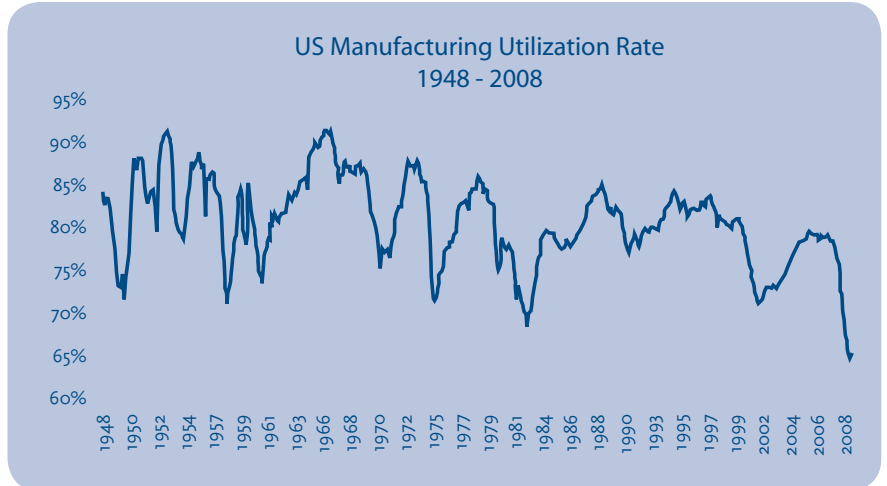
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inadvertently caused a deep recession in 1937-1938.

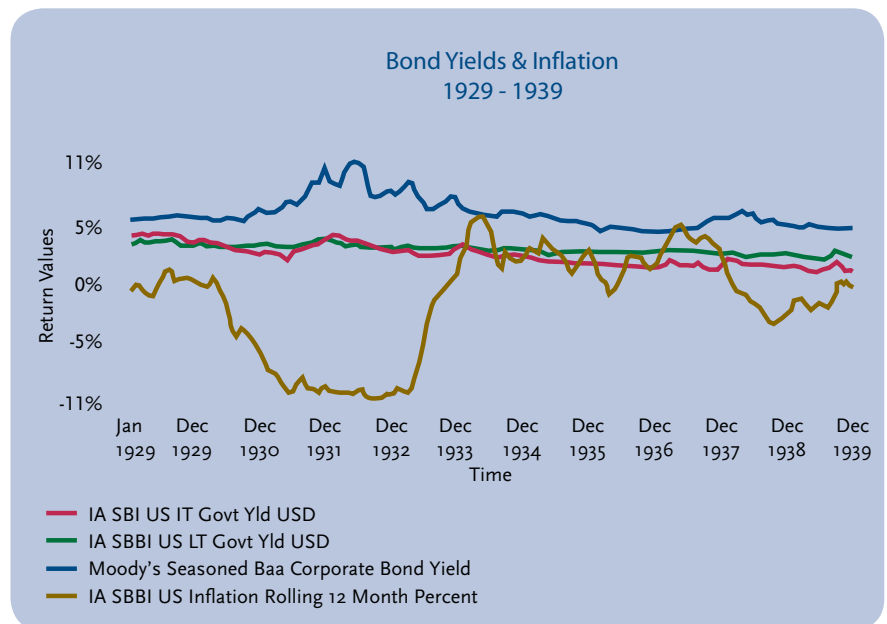
Bond yields can therefore be pushed lower for a longer period than is ever foreseen at the outset of a bubble collapse. Either prolonged weak economic conditions or a miscalculation by central bankers or governments could be the trigger. In the 1930's, for example, yields on government and corporate bonds drifted gradually lower after the initial economic recovery in 1933 as consumer prices dipped in the mid-1930's and dropped sharply in 1938. As illustrated in the following chart, by the end of the decade, yields on intermediate-term and long-term Treasuries (in red and green) were 1.0% and 2.3% respectively while Baa corporate bonds (in blue) yielded 4.9%.

In this low interest rate environment, as tempting as it may be to abandon bonds in search of higher-yielding securities, disciplined investors should stay committed to their asset allocation as per their Investment Policy Statement.

Such discipline will result in capital gains if rates move lower (bond prices go up when interest rates go lower). However, a more important benefit of properly balanced portfolios with broad diversification is a reduction in overall portfolio risk. This allows investors to sleep better at night regardless of the future direction of interest rates.



Source: US National Bureau of Economic Research



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The Future of Interest Rates, continued



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