

Don't bet against Bernanke's inflation quest

By David Rosenberg (FT back page Sept. 10, 2013)

It is time to start hedging against rising long-term interest rates

As the debate rages over who the next Federal Reserve chairman will be, it seems Ben Bernanke's legacy will not just be that he saved the world from financial calamity five years ago: he is also likely to bequeath stagflation, or at least a mild form of it. It is not possible to keep real short-term interest rates negative for this long in the face of even modestly positive real economic growth without generating financial imbalances and inflationary excesses down the road.

The great secular bull market in bonds started in 1981 with inflation and bond yields at 15 per cent, and expected to head higher. With the benefit of hindsight, it is clear the consensus of forecasts at the time underestimated the resolve on the part of Paul Volcker, Fed chairman, to slay the inflation dragon.

It took him four to five years to do so, and it was not until the mid-1980s, when bond yields finally broke below double digits, that the investment community bought into what the Fed was trying to achieve, which was disinflation, followed by price stability.

No doubt it has taken Mr Bernanke far longer to dispel deflation concerns, but I believe he will ultimately be successful in his quest for higher inflation, and my call for higher long-term rates is a new secular view.

Unless you expect deflation or an economic relapse, the timeline for how long bond yields can remain negative after adjusting for the growth rate in nominal gross domestic product, is going to be put to the test.

In fact, this process of bond yields normalising to the trend in nominal GDP began three months ago and is ongoing. Years from now it will be clear that the 1 per cent handles that inflation and 10-year Treasury yields hit at their lows as a secular turning point were the mirror image of those 15 per cent handles just over three decades ago.

While deflation continues to dominate the thought process in the market and at the worlds' major central banks, the reality is that core inflation has bottomed.

Those who cannot see cost pressures emanating from the jobs market should take a harder look at the August employment report, specifically the private sector wage bill, which jumped 0.7 per cent and is up at a 6 per cent annual rate over the past three months.

At the same time, the US economy is likely to do better in 2014 as many headwinds subside. It is against this backdrop that the Fed is probably going to start tapering its quantitative easing programme at the September 18 meeting.

However, the Fed and other central banks are hardly going to be touching short-term interest rates, which will remain negative in real terms for years. So financial repression will remain the order of the day, until the Fed gets what it wants – which is inflation expectations heading up to 2.5 per cent.

It would be an exercise in futility to bet against that desire, just as it was for the bond bears when they bet wrong against the Fed in the opposite direction back in the early 1980s. For a monetary authority that, until several years ago, was debating whether price stability was really closer to 1 per cent than 2 per cent, this is more than just a subtle shift in policy. At a 2.5 per cent inflation rate, the price level would rise by nearly 30 per cent over the coming decade.

This surreptitious default move is one peg in the restoration of a more comfortable debt to GDP ratio. But the policy-driven move towards higher inflation will help devalue the outstanding real level of what are still huge liabilities. That is not price stability: it is more bad news for pensioners and those who live on fixed income investments, and good news for Uncle Sam and other debtors.

It will not be a straight line-up, but the big picture is that the lows in Treasury yields are behind us, and a secular bear market is now in its infancy.

So if you are an issuer, the time for refinancing is now, not later. And if you are an investor, do not spend too long debating whether you should be starting to hedge your portfolio against the prospect of a rising long-term interest rate environment, even as central banks continue to keep short-term policy yields at the floor.

From a wealth management perspective, this means embarking on strategies that over time will effectively hedge out interest rate risk and are correlated with steeper yield curves.

It also means screening in the equity market for companies that benefit in a moderate stagflationary environment, namely those with the capacity to pass on cost increases to protect profit margins. And the income equity theme shifts from dividend yield to dividend growth.

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