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From abundance to scarcity: Implications of higher real rates and lower liquidity

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The Global Financial Crisis (GFC) of 2008/2009 marked a regime shift for inflation, monetary policy, and financial markets. Aggressive monetary policy easing, from zero interest rate policy (ZIRP) to negative interest rate policy (NIRP) and quantitative easing (QE) inflated asset prices for almost a decade.

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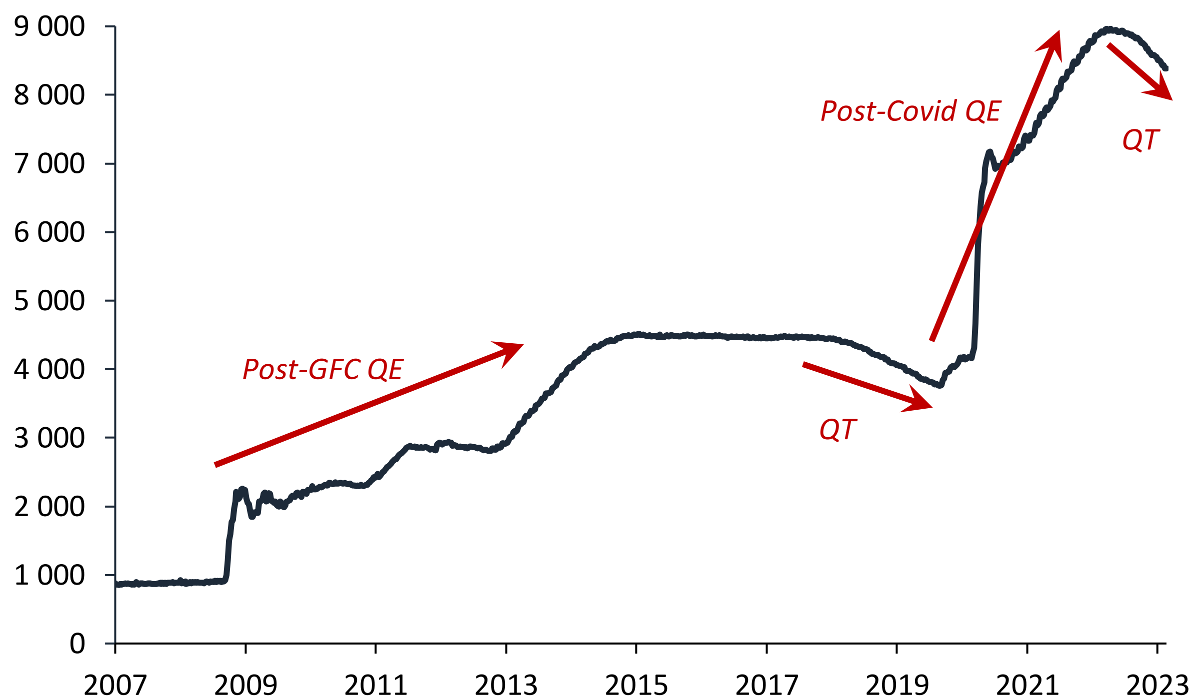
Alongside a gradual interest rate hiking cycle from 2016 to 2018, the US Federal Reserve (Fed) attempted to unwind its balance sheet – called quantitative tightening (QT) – during 2018. However, a softening in US growth and a wobble in the equity market prompted the Fed to reverse course with renewed balance sheet expansion in 2019 (Figure 1). Then the COVID pandemic hit, with NIRP and QE rapidly reinstated. Other developed market (DM) central banks followed suit as the European Central Bank and those in Sweden, Denmark, and Switzerland experimented with ZIRP.

Figure 1: Federal Reserve assets (US$bn)



Source: Bloomberg, Matrix Fund Managers

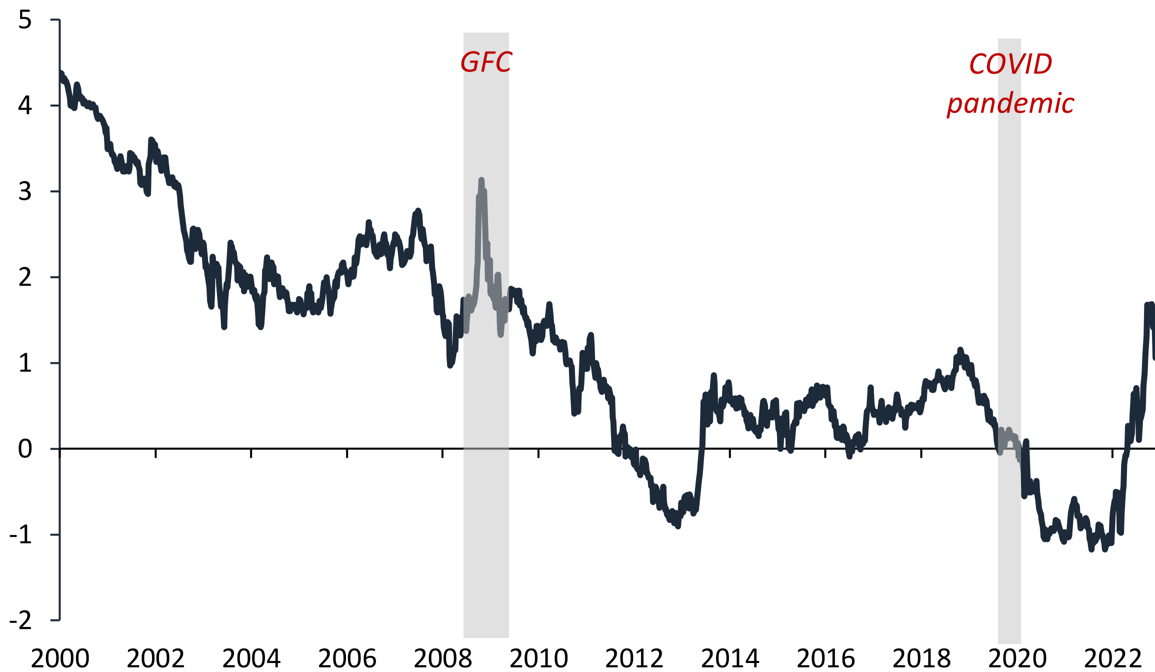
The cost of excessive easing

The differentiating factor in the pandemic policy response was that fiscal policy played a much larger and more durable role in supporting households. Yet this was not without cost. The supply/demand imbalance that ensued resulted in a surge in prices and rampant consumer price inflation in the developed world after decades of disinflation – the so-called "great moderation". While the Fed was arguably late to respond, it did so with gusto in 2022 with a rapid pace of rate hikes and QT. Again, other DM central banks followed suit on both fronts.

This triggered a sharp reaction from real yields – as measured by treasury inflation-protected securities (TIPS)[1] – with the 10-year real yield rising from a low of -1.2% in late 2021 to a high of almost 1.8% in October 2022 (Figure 2). This is similar to the level that prevailed in the late 2000s. As we all know, this reset in real rates made last year a challenging one for returns, as risk assets - from equities to crypto - plummeted.

Figure 2: US 10-year TIPS yield (%)

[1] TIPS are equivalent to South Africa's inflation-linked bonds where the principal value that will be repaid at maturity and that is used to determine the bi-annual coupon is linked to the Consumer Price Index.



Source: Bloomberg, Matrix Fund Managers

Are we facing a regime shift?

As we navigate the ups (in January) and downs (in February) of markets in 2023, we ask ourselves whether 2022 marked another regime shift for inflation, monetary policy, and financial markets. We could be facing a very different world, with sustained positive real rates and yields across the developed world, particularly in the US. Despite all the talk of de-globalisation, we must acknowledge that financial markets are still very much integrated, with the global cost of capital set by the US and the Fed.

Yet, why does it matter whether TIPS yields stay positive? There are a few, often interlinked, transmission mechanisms.

The real monetary policy rate and sovereign real yield curve set the base rate for the cost of capital in an economy. This will have implications for economic growth and the supply of and demand for credit and therefore spending and investment.

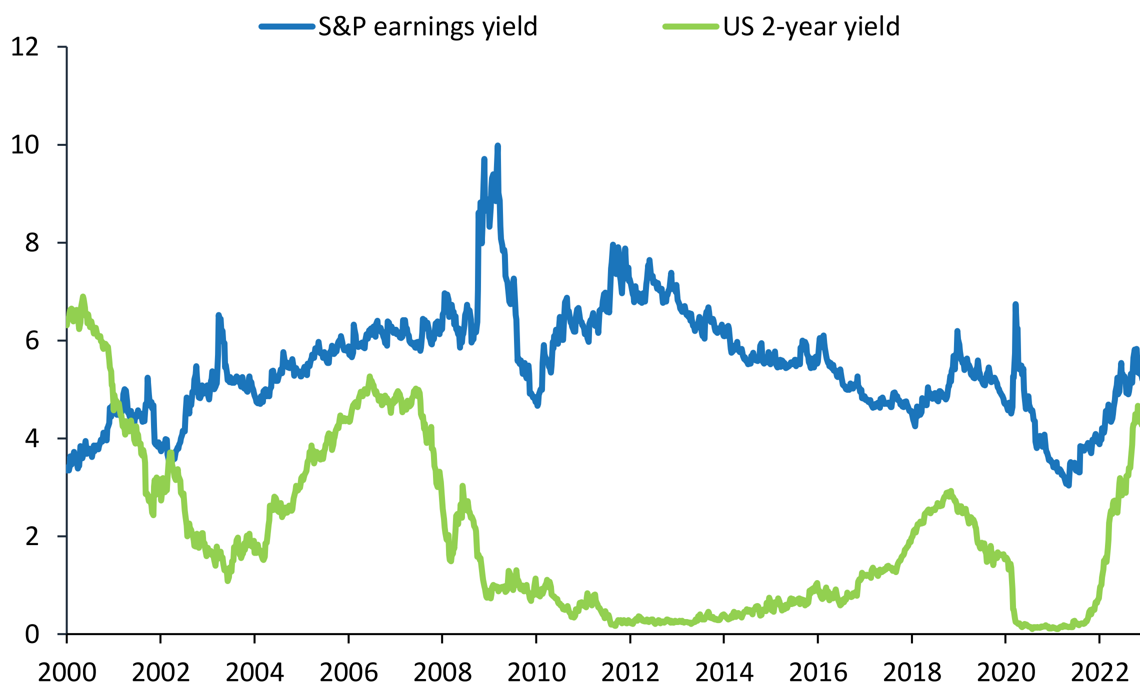
It is also a hurdle rate for competing asset classes. As real and nominal yields steadily declined in the 2010s, equities outperformed because of TINA – there is no alternative. However, following the aggressive Fed hiking cycle (so far), higher nominal and real yields are competing with risk assets. We have entered a world of TARA – there are reasonable alternatives. One could even argue that these alternatives are now more than reasonable with the two-year Treasury bond yielding 4.8% versus an earnings yield of 5.2% on the S&P500 (Figure 3).

The real yield also enters valuations, as it plays a part in the discount rate used in stock pricing models. A higher discount rate implies a lower valuation, all else assumed equal. This, in turn, would lower prospective returns from risk assets.

Higher real yields available from money market and low-risk bond instruments would attract risk-sensitive investment flows, which reduce the liquidity available for competing asset classes. The resultant decline in these competing asset classes could have a negative wealth effect and so reduce confidence and a willingness to

spend. Similarly, lower equity valuations could have a negative balance sheet effect by increasing leverage, which could lead to risk-averse behaviour on the part of banks and corporates. In turn, this could lower fixed investment.

Figure 3: S&P500 earnings yield versus 2-year US Treasury bond yield (%)



Source: Bloomberg, Matrix Fund Managers

From abundance to scarcity – what could it mean for EM?

A new inflation regime of stickier, above-target inflation in DMs could require a sustained tighter monetary policy stance. This could be a combination of a higher real rates and ongoing QT. As such, we potentially face a world that is shifting from abundant liquidity to a relative scarcity. The implications for emerging markets (EMs) and South Africa could be significant.

Importantly, in analysing financial markets we will not be able to rely on excess liquidity as the primary driver of asset prices. We all know the adage "a rising tide lifts all boats", but in a less abundant world, fundamentals will play a greater role in determining returns.

For countries that rely on foreign savings to supplement domestic investment, foreign portfolio flows into domestic bond and equity markets will likely be lower, all else assumed equal. US investors need not take on excessive risk when they can obtain a decent 5% return in the US money market.

Hence, EMs and SA may need to "pay up" for foreign inflows, which would mean trading at a larger discount to enhance prospective returns or paying a higher yield in the money and bond markets. This would obviously have negative implications for the local economy, as a higher risk-free rate would raise the cost of capital. Fortunately, SA debt and equity markets are already trading at material discounts to global averages. However, in this environment these discounts would likely persist.

In a less abundant world, EM central banks may be forced to maintain a relatively tight monetary policy stance. The reason could be two-fold: to attract capital inflows from offshore, and to force domestic savings to increase despite the potential downside to growth. This is arguably what we are witnessing, given the ongoing hawkish bias from the South African Reserve Bank and other EM central banks.

We are not advocating a regime shift. The Fed could very well blink if/when a recession ensues, but we are cognisant that a regime shift will have consequences for portfolios. Therefore, it is important to build robust portfolios. One's investment philosophy should not be regime-dependent. Rather, a robust process is required to build portfolios that can adapt to new regimes.

Glacier Research would like to thank Carmen Nel for her contribution to this week's *Funds on Friday*

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Carmen joined Matrix Fund Managers in July 2017 as an economist. She is responsible for research on the South African and global economies and key financial markets and co-manages the long-only bond fund mandate at Matrix. Prior to moving to the asset management industry, she was co-head of Rand Merchant Bank's Global Markets Research division, responsible for coordinating the macro and fixed income views and marketing to the bank's institutional client base. Carmen has 20 years' experience, covering macro and financial markets and has worked as an economist at Bank of America Merrill Lynch, Citi and Deutsche Bank. She has won numerous industry awards. Carmen studied BSc Actuarial Science at undergraduate level and has two Honours degrees: a BSc in Mathematical Statistics (University of Johannesburg) and a BSc in Advanced Mathematics of Finance (WITS). She is also a CFA® charter holder with the CFA Institute and an FRM® charter holder with the Global Association of Risk Professionals.

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