

## Markets aren't pricing rates

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Tim Farrelly | farrelly's | 27 April 2018

Markets aren't pricing in the possibility that interest rates revert to the old normal – that's the view that Guy Debelle, Deputy Governor of the Reserve Bank of Australia, outlined in a [recent speech](#). It is worth reading in full, but a vastly oversimplified summary is as follows:

Markets appear to be assuming that interest rates will stay low forever and don't seem to be taking any account of the possibility that rates may revert back to significantly higher levels. If they do, look out – equity and property markets will be significantly re-priced downwards.

It's a timely warning – but what do we do with it? I think it depends on your investment time horizon, as do so many investment decisions.

If you make decisions with a short- to medium-term time frame in mind, you face a real dilemma.

If rates do stay low for the long term, asset prices are fine and equities and property will outperform cash by a tidy margin. If, on the other hand, the market forms a view that interest rates will revert back to the old normal, asset prices should fall sharply – around 20% by my estimation, and may overshoot further.

As a medium-term investor, you will need to form a strong conviction as to which of the two states is most likely and so make a choice as to whether to stay fully invested or move largely to cash. Alternately, you may have the view that you will be able to divine the future state of the world before the markets and so sell out before markets correct. In either case, these are high stakes, winner-takes-all positions.

On a longer-term investment view, the game changes completely. By my estimate, if rates stay low, cash will return around 3% per annum over the next decade and equities will return 7% to 8% per annum. If rates revert to the old normal, then equities should return 5% to 6% per annum, while cash rates will average around 4% to 5% per annum. In both cases, equities win.

As is so often the case, taking a longer-term view makes a difficult investment decision a lot easier. The riddle is why more investors don't do just that.



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