Dimensional

OUTSIDE THE FLAGS

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Interest Rate Wheel

Forecasting interest rates is a tough job. Even when you get it right, there's no guarantee the market will react as you expect. The good news is you don't need to be able to forecast rates to earn the returns from fixed interest.

The financial media allocates a great deal of space to the prognostications of commercial bank economists on the likely timing and direction of interest rate changes by central banks around the world.

The media's rationale for the intense coverage is that interest rate changes affect so many people, from business borrowers to people scrambling to pay off big home mortgages to retirees seeking income from bank term deposits.

Speculation around rate moves is also an easy (and cheap) story to cover. You just line up the talking heads before the announcement and ask them their forecast. And then you line them up again afterwards to ask why they got it so wrong.

It's a tough job for the forecasters. Not only do they have to pick the direction and timing of the rate changes. They have to anticipate how the market will react. And that's not always as obvious as you might think.

The recent experience in Australia provides a case study. In February, just seven out of 29 economists polled by *Bloomberg News* forecast the Reserve Bank of Australia would cut its benchmark cash rate at its monthly policy review.

As it turned out, the bank confounded the forecasters, lopping the cash rate by a quarter of a percentage point to a then record low of 2.25%. The local share market surged to an almost seven-year high on the unexpected move, bond yields fell to record lows and the Australian dollar dropped 2% against the US dollar.

The futures market immediately priced in a 70% chance of the RBA following up that rate cut with an equivalent move in March. Of the *Bloomberg* panel, a slight majority of economists (18 out of 29) expected a March reduction.

But again, the majority of economists were wrong. The central bank left the official cash rate on hold in March. With the markets expecting a different result, shares fell, the local currency rose and bond yields climbed.

By April, economists were starting to doubt themselves. While the futures market had virtually priced another rate cut, only the barest majority of seven out of 30 economists expected the second move would happen then. Sure it enough, it didn't.

By May and with much signaling from the RBA, an overwhelming majority of 25 out of 29 economists were convinced the central bank would act to loosen policy. And this time, they got it right. The Reserve Bank shaved the cash rate by a quarter of a percentage point to a record low of 2%.

But picking the rate timing is only half the job. The economists also had to predict how the market would react. A news story ahead of the decision quoted one major bank as saying an interest rate reduction would hurt the $A and boost shares.

That was unfortunate for short-term traders, because the immediate market reaction was just the opposite, with shares falling and the local currency rallying. The reason, we were told, was that the market focused on a change in the central bank's forward guidance which suggested to some that no further rate cuts were in store.

It should be plain from all this that basing an investment strategy on forecasting changes in interest rates is a very difficult, if not impossible, job. And remember, these forecasters are people whose profession it is to read the policy tea leaves.

The good news is you don't need to be a fortune teller to generate a successful long-term investment experience from bonds. The markets' collective expectations for interest rates going forward are already evident in today's pricing.

The second point is that these expectations are always changing, depending on what is going on in the economy and other factors. The market may expect a rate cut, but then change its collective view after an upside surprise in inflation.

A third observation is that official interest rates and rates in the wholesale markets, as expressed in bond yields, do not move in lock-step. Long-term borrowing rates may rise as short-term rates fall, and vice versa. The short end of the market may be more influenced by central bank changes; the long end by global influences.

Instead of trying to anticipate rate moves, we can shift our allocation to the term risk in bonds depending on the opportunities on offer. When there is little difference between short and longer-term rates (as we have seen in Australia in recent years), there may not be a reward for taking on much maturity risk.

There is also no guarantee that your bond portfolio will do badly when official interest rates are rising. (See portfolio manager Steve Garth's **paper** on this). And keep in mind that even when bonds *are* doing poorly relative to shares, they still offer a diversification benefit in a portfolio.

Fourth, interest rates vary across different markets. The shape of yield curves (the trajectory drawn by bonds of the same credit quality and different maturities) can be significantly different in the US, the UK, Europe, Japan or Australia.

Hedging out the currency risk of all those yield curves to the Australian or New Zealand dollar broadens our opportunity set and ties global yield curves to local cash rates. (Dr Garth's **new paper** on the mechanics of hedging provides detail.)

So the upshot is that while it is impossible to predict what will happen with interest rates, we can still build diversified fixed interest portfolios that take advantage of what today's market pricing tells us. We can shift maturities depending on the available reward and invest globally to increase diversification.

This investment approach is all about controlling what we can control. It doesn't mean there will never be rocky times in the bond market. It does mean we are leaving as little as possible to chance.

At the end of the day, there's no need to spin the interest rate wheel.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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