Dimensional

OUTSIDE THE FLAGS

Rate Expectations

Jim Parker
Vice President

Nov 04, 2022

If you consume enough financial media, you'll notice that much time and space is spent wondering what central banks will do next with benchmark interest rates. But while this constant speculation fills a gap, it can serve as a distraction for long-term investors.

Underpinning the obsession in media about the utterances and actions of central bankers – like the US Federal Reserve, the Reserve Bank of Australia (RBA) and the Reserve Bank of New Zealand (RBNZ) – are a number of assumptions.

LEADING OR FOLLOWING?

The first of these is that interest rate decisions by central banks lead the market, when in reality it is often the other way around. The central banks tacitly admit that themselves when they say their future decisions are "data-dependent".[1]

That phrase implies that their current view on the correct level and likely course of official interest rates may change as new information comes to light about inflation, economic growth, unemployment and other variables.

In other words, the policymakers don't have any more information or insight than the market itself. We are all working off the same signals, which means the central banks can be behind the market in coming to a conclusion about where rates should be set.

THE AUSTRALIAN EXPERIENCE

Think back to November 2020, about eight months after the pandemic was declared. The RBA cut its official cash rate to a record low of 0.1% - virtually zero – and lowered its target for three-year Australian government bonds to the same level.[2]

Given the significant uncertainty surrounding the path and economic impact of the coronavirus at that point, the bank's governor Philip Lowe said the RBA was not expecting to increase the cash rate "for at least three years" or until inflation was

sustainably within the bank's 2-3% target range.[3]

But then things changed. Soon after the RBA announcement, there was a breakthrough on the development of vaccines. By 2021, the economic recovery was stronger than expected. And later that year and with market-set interest rates increasing, the bank had to abandon its policy target for the three-year government bond. In other words, the market, responding to the same information, had essentially forced the RBA's hand.[4]

By this time, inflation was starting to pick up again as well. In some advanced economies, headline rates were above 4%.[5] But the view of the RBA governor, like those of other central bankers, was that this was likely to be a "transitory" phenomenon as increased demand was running up against pandemic-related supply constraints.[6]

"The latest data and forecasts do not warrant an increase in the cash rate in 2022," Dr Lowe said in November 2021. "The economy and inflation would have to turn out very differently from our central scenario for the board to consider an increase in interest rates next year."

But this is precisely what happened. In the March quarter of 2022, Australia's annual inflation rate rose to 5.1%. This result, a 20-year high, exceeded market expectations and was fuelled by the rising costs of building supplies, petrol and groceries.[7]

Having abandoned its attempt to control the yield curve six months before, the RBA in May now walked away from its cash rate forecasts as well and raised the benchmark rate to 0.35% in the first policy tightening in more than a decade.[8] Rates continued to rise from that point as inflation ratcheted higher.

In making this decision, Governor Lowe described the central bank's guidance that interest rates would not rise until 2024 as an "embarrassing" error and announced an official review into how the bank had got its forecasts so wrong.[9]

The lesson for investors here is that central banks have no more information than the market itself and are just as data-dependent as anyone.

WHICH INTEREST RATE?

When the media talks about "interest rates" it usually means benchmark rates. In reality, there are thousands of rates. These are set by buyers and sellers in the bond market and vary by the maturity, credit quality and currency of issuance. As we have seen, these rates move independently and often well ahead of central bank benchmarks.

Bond prices, and therefore yields, change every day based on changing economic conditions, risk appetites and information about individual issuers.

This means investors can build diversified fixed interest portfolios in which their exposure to key determinants of risk and return in bonds – duration, credit and currency – can vary according to their goals. These goals include preserving capital, managing the volatility of your overall portfolio or seeking total return.

The point about bonds is there is information in today's market about two components of

their return – the yield or interest rate of the bond, plus the expected capital gain or loss based on today's prices. A third component – the future change in yield is not observable. So certainty, even with bonds, is not completely attainable.

Even so, we know more about future cash flows with bonds than we do with equities and we know that we can manage risk by diversifying. Your exposure to term and credit, two of the sources of risk and return in bonds, can vary depending on your goal.

THE BIG PICTURE

So you can see that there is much more to investing in bonds than just following what central bankers are doing. As we have seen, they are as much in the dark as anybody else and can change their minds as the economic data changes.

While bonds had a bad start to 2022, certainly worse than anything we have seen for decades, that says nothing about likely future returns.[10] For many years now, people have been complaining about ultra-low interest rates from bonds. Well, now rates and expected returns are significantly higher. And while you would have suffered a capital loss from bonds earlier this year, you have the opportunity to earn a higher income from bonds than previously and a chance to make a capital gain.

Though less volatile than stocks, bonds are nevertheless risky assets. And while this year's poor returns from bonds is unusual, it is not unexpected.

Finally, we know that markets do a pretty good job of pricing risk. And with bond yields now significantly higher than they were a year ago, there is an opportunity for investors to use that information in prices to generate higher expected returns.[12]

For investors for whom capital preservation is the prime consideration, there is the option of staying in short-term, high quality bonds.

As always with investment, it comes down to the goal.

1. 'Data Dependent Monetary Policy in an Evolving Economy', Jerome Powell, *Federal Reserve*, 8 Oct 2019.
2. 'Reserve Bank Cuts Interest Rates to Record Low of 0.1%, *ABC News*, 3 Nov 2020.
3. Statement by Philip Lowe, *Monetary Policy Decision*, 3 Nov 2020.
4. 'Get Used to Bond Market Turmoil as RBA Seen Behind the Curve', *Bloomberg*, 3 Nov 2021.
5. 'Euro Zone Inflation Hits 13-Year High Above 4%', *Europe News*, 29 Oct 2021.
6. 'Recent Trends in Inflation', RBA Governor Philip Lowe, *Speech to ABE*, 16 Nov 2021.
7. 'Consumer Price Index, Australia', *Australian Bureau of Statistics*, 27 April 2022.
8. 'Australia's Central Bank Hikes Interest Rates, Flags More to Come', *Reuters*, 3 May 2022.
9. 'Lowe Admits Embarrassing Error on 2024 Rate Rise', *Australian Financial Review*, 3 May 2022.
10. Dimensional Returns Program.
11. 'Riding Out the Bond Market Storm', Dave Plecha, *Dimensional,* 24 Aug 2022.
12. 'Bonds Demystified', Bhanu Singh, *Dimensional*, 24 March, 2022.

The information in this material is intended for the recipient's background information and use only. It is provided in good faith and without

any warranty or representation as to accuracy or completeness. Information and opinions presented in this material have been obtained or derived from sources believed by Dimensional to be reliable, and Dimensional has reasonable grounds to believe that all factual information herein is true as at the date of this material. It does not constitute investment advice, a recommendation, or an offer of any services or products for sale and is not intended to provide a sufficient basis on which to make an investment decision. Before acting on any information in this document, you should consider whether it is appropriate for your particular circumstances and, if appropriate, seek professional advice. It is the responsibility of any persons wishing to make a purchase to inform themselves of and observe all applicable laws and regulations. Unauthorized reproduction or transmission of this material is strictly prohibited. Dimensional accepts no responsibility for loss arising from the use of the information contained herein.

This material is not directed at any person in any jurisdiction where the availability of this material is prohibited or would subject Dimensional or its products or services to any registration, licensing, or other such legal requirements within the jurisdiction.

"Dimensional" refers to the Dimensional separate but affiliated entities generally, rather than to one particular entity. These entities are Dimensional Fund Advisors LP, Dimensional Fund Advisors Ltd., Dimensional Ireland Limited, DFA Australia Limited, Dimensional Fund Advisors Canada ULC, Dimensional Fund Advisors Pte. Ltd., Dimensional Japan Ltd. and Dimensional Hong Kong Limited. Dimensional Hong Kong Limited is licensed by the Securities and Futures Commission to conduct Type 1 (dealing in securities) regulated activities only and does not provide asset management services.

Risks

Investments involve risks. The investment return and principal value of an investment may fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original value. Past performance is not a guarantee of future results. There is no guarantee strategies will be successful.

AUSTRALIA

This material is issued by DFA Australia Limited (AFS Licence No. 238093, ABN 46 065 937 671). This material is provided for information only. No account has been taken of the objectives, financial situation or needs of any particular person. Accordingly, to the extent this material constitutes general financial product advice, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to the investor's objectives, financial situation and needs. Investors should also consider the target market determination that has been made for each financial product either issued or distributed by DFA Australia Limited prior to proceeding with any investment. Go to dimensional.com/funds to access a copy of the relevant target market determination. Any opinions expressed in this material reflect our judgement at the date of publication and are subject to change.

NEW ZEALAND

This material is issued by DFA Australia Limited (incorporated in Australia, AFS License No. 238093, ABN 46 065 937 671). This material is provided for information only. This material does not give any recommendation or opinion to acquire any financial product or any financial advice product, and is not financial advice to you or any other person. No account has been taken of the objectives, financial situation or needs of any particular person. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to the investor's objectives, financial situation and needs. Investors should also consider the Product Disclosure Statement (PDS) and for the Dimensional Wholesale Trusts the target market determination (TMD) that has been made for each financial product or financial advice product either issued or distributed by DFA Australia Limited prior to acquiring or continuing to hold any investment. Go to dimensional.com/funds to access a copy of the PDS or the relevant TMD. Any opinions expressed in this material reflect our judgement at the date of publication and are subject to change.

dimensional.com