Low Interest Rate Inflates Asset Bubble

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Inflation Erodes Value

- Those experienced high inflation in the past knows inflation erodes value.
- Inflation makes your money smaller.
- But certain amount of inflation is good.
- It allows people to work harder to earn more (& also invest).
- It allows companies to continue to grow (& asset value to appreciate).

What Causes Inflation

- **According to economists, inflation is due to too much money chasing after limited goods.**

- **There are many other reasons that cause inflation**
  - **Higher cost of production** (higher material cost due to weather)
  - **Supply disruption** (eg war)
  - **Limited supply** (eg monopoly, hoarding, supply chain problem)
  - **Inability to meet sudden surge in demand**
  - **Easy money** (eg low interest rate, easy credit)
  - **Confidence to spend** (eg after few years of good economy)
  - **Fear of inflation** (afraid prices will go up further)

High Inflation -> Higher Interest Rate

- Higher inflation is likely to lead to higher interest rate. Government may up interest rate to curb inflation.

- Important to know what causes inflation.

- Increase interest rate is not the only way to curb inflation.

- Other methods - increase supply, increase competition, curb on consumer credit, etc

Our View - Low Inflation

- Our longer term view is that inflation will go up, but not excessive.

- Our reasons are:-

(a) Improved productivity reduces cost

(b) Larger economies of scale reduces output cost

(c) New economy - uses less energy & materials

Improved Productivity

- One of the main proponents of low inflation going forward is the increase in productivity in this modern age.

- The use of telecommunication increases productivity (eg computerisation, internet, mobile phone, smart phone).

- The awareness to reduce cost forces corporations to think of alternatives (eg Just-in-time, outsourcing).

Economies of Scale

- Larger scale of production reduces cost.
- Larger factories in China is feasible due to the large population (factory of the world).
- Larger operations can be formed via merger (popular in the West).
- Globalisation allows companies to expand and supply to larger market.
- Many products sold at yester-year prices. (eg clothing, footwear, computer)

New Economy

- New economy (eg services) is less reliant on energy and raw materials.
- That is the main reason why even when oil price went above US$100/barrel, many countries can still function.
- Oil is used as fuel and basic materials.
- Oil being the most important input to most industries is the best measure to test this theory.
- Usage of oil per GDP is falling worldwide.

No Immediate Fear of Inflation

- Despite the jump in supplies of money in the West, inflation will still be mild.

- The reasons are:-

  (a) People are cautious in spending after a recession

  (b) Velocity of money is slow as banks are reluctant to lend

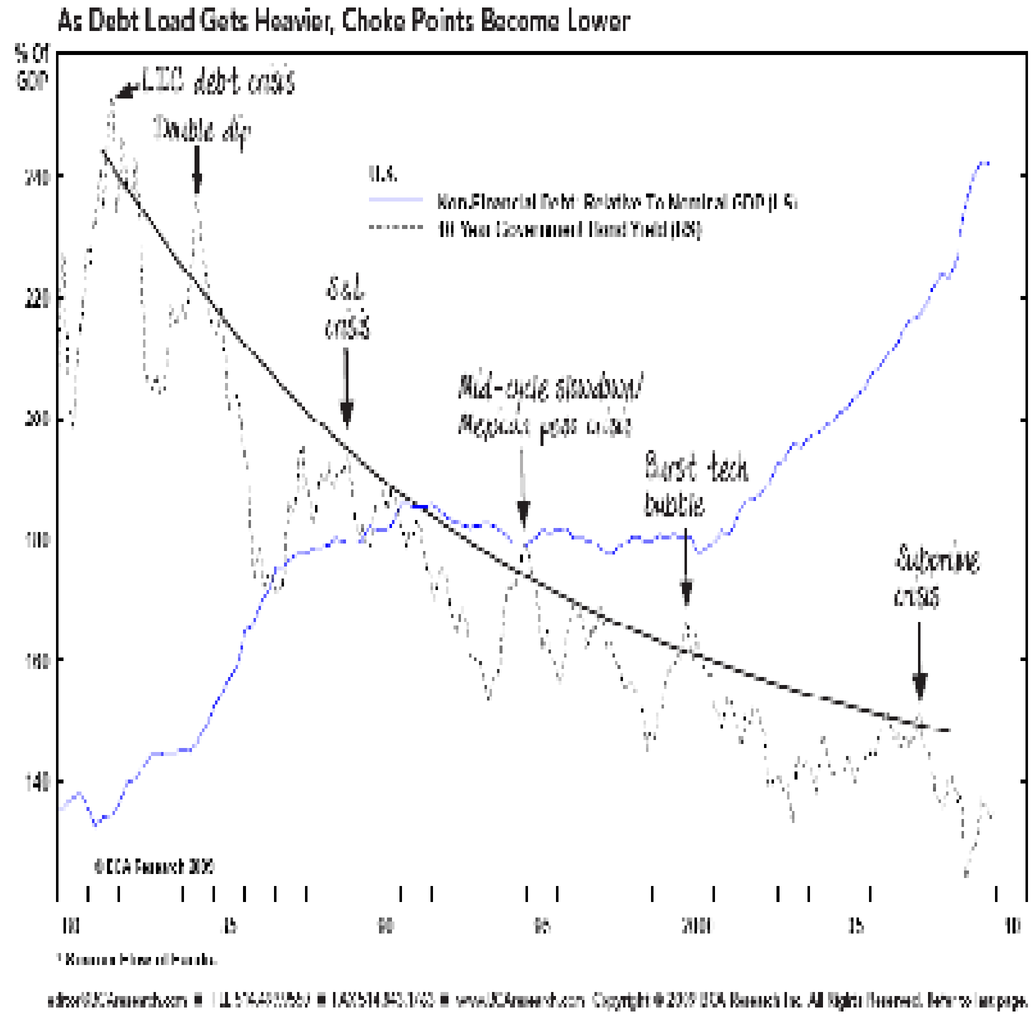
  (c) The 30% spare capacity in the West will easily be used to meet increased demand.

  (d) US has started to reduce money supply

- China targets 9% growth but only 3% inflation this year.

Interest Rate Trends Lower

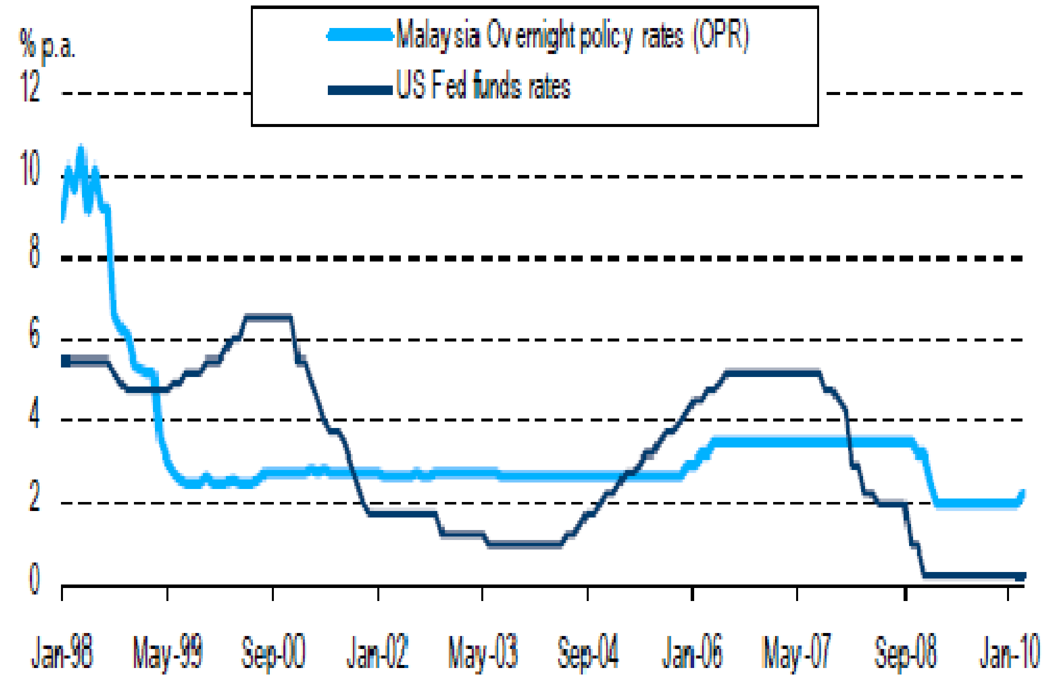
- **Global interest rates are trending lower.**
- **Falling inflation is one of the main reasons.**
- **Increased productivity helped to contain inflation.**
- **Inflation & hence interest rates may rebound, but they are unlikely to go up excessively.**



Malaysia OPR Still Low

- **BNM kept OPR 2-4% for last 10 years.**
- **US uses Fed Fund Rate more aggressively.**
- **Since our interest rate is higher than that of US there is no hurry to increase rate.**
- **But our lending rate trends lower.**

Figure 1: The normalisation of interest rates is on



Note: The lowest SRR ratio was 2.5% in Jan 1989

Prior to 2004, the policy interest rate was the intervention rate. After 2004, the policy rate is the overnight policy rate.

Source: Bloomberg, BNM

Normalised Interest Rate

- Bank Negara governor recently hiked interest rate not because of fear of inflation.
- She said "too low an interest rate may cause people to take excessive risk to invest".
- She implies that low interest rate will encourage speculation, leading to asset inflation (not consumer inflation?) and hence asset bubbles.
- Normalisation of interest rate is a new phenomenon.

Low Interest Rate -> Carry Trade

- **When yen interest rate is low, many borrow cheap yen and invest in other countries and other assets.**

- **Now US interest rate is also low, a larger US$ carry trade is emerging. This leads to a new source of fund which flows to many parts of the world - bonds, equities, properties, commodities, etc.**

- **Many countries are facing this "hot money" that stirs asset bubbles.**

- **Some countries are imposing restrictions and taxes to curb the hot money.**

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Low Interest Rate for Extended Period

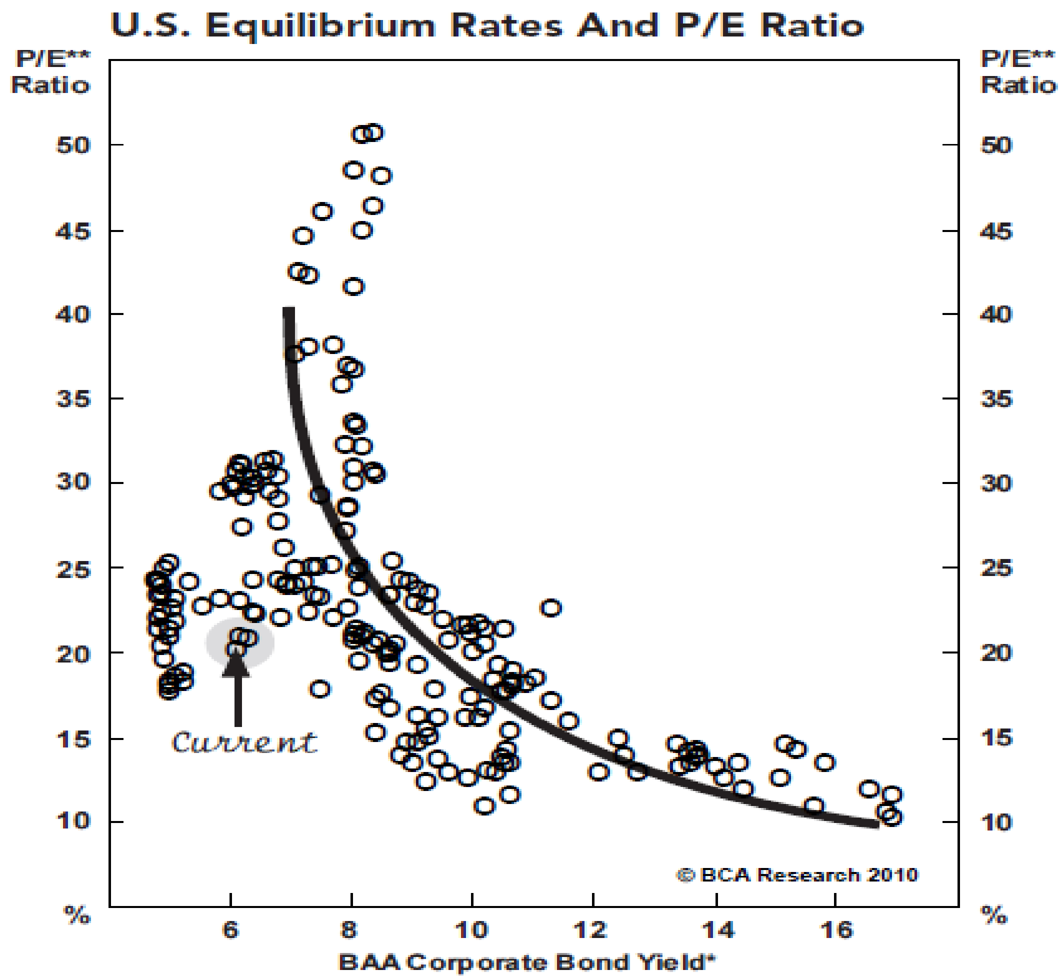
- US has repeatedly said to maintain low interest rate for an extended period.
- Most countries are waiting for US to make the first move.
- Rate hike by Australia did not attract much followers.
- US wants to ensure a stronger recovery before increasing interest rate.
- By doing so, US is fuelling asset bubbles worldwide.

Interest Rate Will Be Up Eventually

- At such a low level, interest rate cannot go down further.
- It is likely to go up one day. Just that, US wants it to go up later then sooner. Timing also depends on US economic recovery.
- In the mean time, market is enjoying the cheap money.
- Even if interest rate is up, it will not go up substantially.
- One rate hike will not kill the market, a series will.

Low Interest Rate, High PE

- **When interest rate is low, more money flow to the equity market.**
- **Low interest rate allows market to trade at high PE ratio.**
- **PE of 10x means 10% earnings yield, 20x means 5% earnings yield.**



* Source: Moody's Investor Services.
** Based on cyclically-adjusted earnings.

Short Term View

- We believe so long as US keep interest rates low to ensure sustainable economic recovery, equity market will remain bullish.

- Market may take a sharper correction, when US decides to up interest rate. Two reasons:-

  (a) Higher interest rate will force those in US$ carry trades to unwind their positions to sell assets and repay US loans.

  (b)Stronger US$ will also force some hedge funds to sell non-US assets.

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Longer Term View

- We repeat - interest rate will go up but not too high.
- Relatively low interest is conducive for investment.
- Rental yield higher than FD rate -> support property prices.
- Dividend yield higher than FD rates -> raise stock prices.
- Stock market can sustain higher PE in low interest rate environment. For the same earnings, it means prices will be higher.

Conclusion

- Market will be affected by US interest rate hike later part of this year, a risk that cannot be ignored.
- When interest rate is raised, market will fall. How sharp the market correction will depend on how aggressive the rate hike will be.
- Our longer term view of the equity market is still bullish.
- More aggressive buying should be made after US hike interest rate.

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