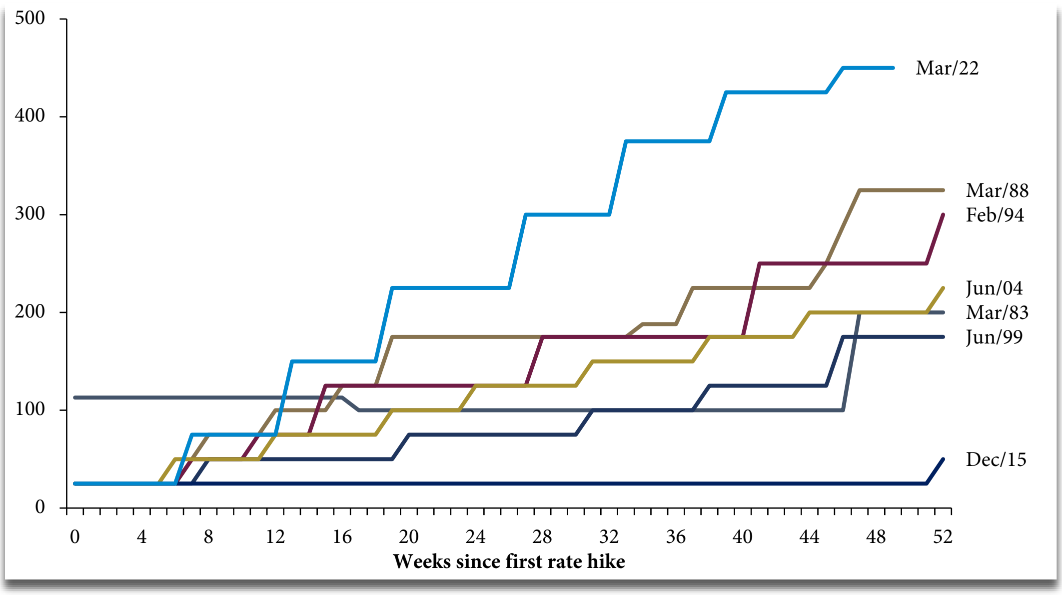
For your interest (rates)

There has been a lot of attention on interest rates over the last year, and understandably so, given that 12 months ago marked the starting point for the most aggressive central bank tightening campaign in the last four decades by a wide margin.

Higher, further, faster

(change in US fed funds rate target midpoint; basis points)



Source: Guardian Capital based on data from Bloomberg to February 24, 2023

Moreover, should the increases in market interest rates seen so far this year — that have taken government bond yields to their highest levels in more than a decade — be sustained, it would mark the third consecutive year of rising rates, something that has not happened in more than 40 years.

In other words, very few current investors have experienced what is happening in bond markets in their professional lives — and there is a considerable share of the working-age population for whom it is a new experience to have borrowing costs materially different from zero.

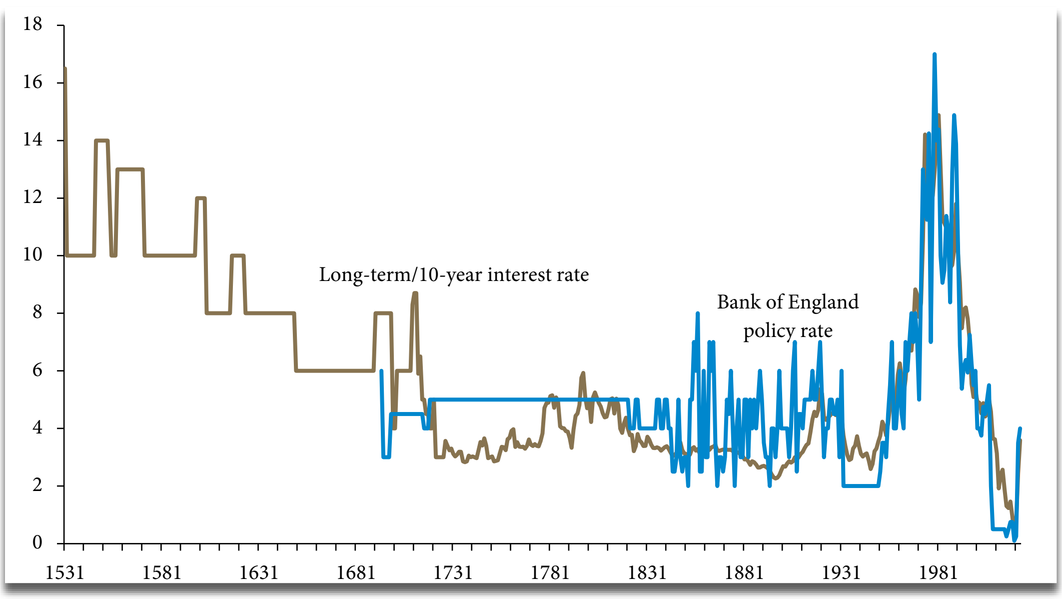
Of course, though, history shows that the last decade and a half has been the real outlier. The low level of interest rates experienced since the Global Financial Crisis — and particularly the plunge in market rates in response to the surge in monetary stimulus after the onset of the pandemic three years ago that saw a peak of 30% of bonds globally trade with negative yields — have marked an all-time low. And by all-time, that means all of human civilization effectively.

Looking at the history of "official" rates, the Bank of England was founded in 1694, and the bank rate was set at 6% upon its inception — the rate averaged about 5% over the 300 years leading up to the turn of the millennium. Before January 2009, it had never been below 2%, not during significant banking crises in the 1880s and 1890s, not during the Great Depression of the 1920s and 1930s and not during World War II. It was set at a record low of 0.1% in March 2020 and only just returned above 2% this past September.

Data and estimates for longer-term market interest rates show that costs of borrowing largely tracked those benchmark rates since their inception. Records show that bonds issued to finance integral infrastructure projects, such as American rail-roads during the boom from 1870 to 1900, had average coupons around 5%, while the US government was able to issue bonds to fund the construction of the Panama Canal at rates of 2% and 3% from 1906 to 1911 (French bonds to start the project carried coupons of 4%, initially); "Victory Loans" issued by the Canadian government to fund its participation in World War I carried interest rates between 5% and 5½%, while those to help finance World War II saw coupons from 3% for longer maturity and under 2% for those with shorter durations.

Taking a long look

(United Kingdom's benchmark interest rates; percent)



Source: Guardian Capital based on data from the Bank of England, Measuring Worth, Organisation for Economic Co-operation and Development, and Bloomberg to February 23, 2023

Looking back before the introduction of central banks as lenders of last resort, the broad risks associated with credit translated into higher interest rates. Double-digit interest rates were common as per transaction accounts compiled by economic historians. For example, the 20,000 ducat loan to the French King Charles VIII, to fund his invasion of Italy in 1494 carried an interest rate of 14%.

Going back further still, interest rates were even higher. The first written evidence of interest rates dates back to Sumer around 2400 BC, with the going rate for loans of grain running between 20% and 50% per year — Hammurabi, a Babylonian King from 1792 to 1750 BC, established limits on interest rates of 20% on loans of silver and 33.3% on loans of grain.

This is all to highlight that the recent experience of low (and zero and negative) interest rates is historically unprecedented. To the extent that markets ultimately revert to the mean, it was only a matter of time before rates moved away from those anomalous levels — the adjustment, however, has been far less fun for investors than the reversion from the "overshoot" of the 1970s and 1980s when central bankers aggressively tightened policy to combat inflation that spurred a four-decade bond bull market.