Are interest rate cycles a thing of the past? Have we entered an age of permanently cheap capital? It is astonishing to be asking these questions, but these are extraordinary times. For construction and real estate developers – and investors – it would be helpful to know whether low borrowing rates are a cruel fantasy with imminent expiry or something closer to a settled equilibrium. Is debt refinancing at today’s rates a gross distortion of reality or the shape of things to come?

There are at least three versions of the thesis that we are living in an age of low interest rates. The first is the ‘ice age’ thesis, long expounded by Albert Edwards, the ultra-bearish global strategist at French bank Société Générale. He has argued for many years now that the world is rushing inexorably into a financial ice age, with the developed world following Japan into an era of collapsing bond yields with imminent expiry or something closer to a settled equilibrium. Is debt refinancing at today’s rates a gross distortion of reality or the shape of things to come?

The second version is the ‘collapsed roof’ thesis: that the journey towards deflation and negative interest rates is an incomplete adjustment to a new, if unstable, equilibrium. The collapsed roof thesis asserts that the new equilibrium is already here and central banks are constrained by it. The socialist utopia thesis is that the existing policy framework is fundamentally flawed and should be abandoned in favour of a new and better equilibrium. What these three theses have in common is a failure to acknowledge that there is an external corrective force, whether of mean reversion or of broader normalisation, which will bring the reign of very low nominal interest rates to an end.

There are two powerful corrective forces that threaten to overturn the era of low inflation and low nominal interest rates. At Economic Perspectives we have showcased each of them in recent seminars. Blowing up the Box on 26 June, and The Coming Collapse of Corporate Credit on 10 October.

‘Blowing up the box’ refers to the obsolescence of the macro policy framework, or box, that has prevailed in advanced western economies for the past 35 years. This box, designed to lock in low inflation, uphold fiscal discipline and rebuff political interference, is now in mortal danger, charged with inadvertently crystallising and compounding relative economic advantage and disadvantage over the past decade (see figure 1). We stand at the threshold of a policy revolution that will blow up the box, overriding the primacy of the inflation objective and abandoning fiscal orthodoxy into the bargain.

As political economy overrides the ‘new normal’, the policy box is set to explode, bringing a reordering of policy priorities. Central banks will probably be reassigned to the defence of sovereign credit in the context of ambitious public spending programmes and the continued repression of nominal interest rates. In practice, the inflation objective will be jettisoned, and the inflation rate will find a new level, paving the way to significantly higher nominal borrowing costs.

The second threat arises from the unavoidable connection between the cost of private sector borrowing and the return on capital, illustrated for UK non-financial companies in figure 2. A side effect of financial repression is the compression of the net rate of profitability as capital discipline is eroded. The downturn in global corporate profitability and net cash generation is well under way and is intersecting with a skewed distribution of indebtedness: profitability and net cash generation is well under way and is intersecting with a skewed distribution of indebtedness:

- The third version is the ‘collapsed roof’ thesis: that the journey towards deflation and negative interest rates is an incomplete adjustment to a new, if unstable equilibrium. The collapsed roof thesis asserts that the new equilibrium is already here and central banks are constrained by it. The socialist utopia thesis is that the existing policy framework is fundamentally flawed and should be abandoned in favour of a new and better equilibrium. What these three theses have in common is a failure to acknowledge that there is an external corrective force, whether of mean reversion or of broader normalisation, which will bring the reign of very low nominal interest rates to an end.

Central bank financial repression – expressed until now as the suppression of nominal interest rates, the elimination of the term premium and the compression of corporate credit spreads – appears to be losing its grip on the pricing of the weakest credits. We expect that central bank responses, cuts in short-term rates or the resumption of quantitative easing (QE) will be unable to prevent this bifurcation in the pricing of corporate credit.

To summarise, the reign of low nominal interest rates is under siege from a prospective macro policy revolution that up-ends priorities and opens the inflationary valve. The era of low corporate borrowing costs is additionally vulnerable to a fracture in the pricing structure for private sector credit, leaving a significant segment of the market with elevated borrowing costs as a new bond and loan default cycle unfolds.

**Figure 1: US real family income 1947-2014**

(percentage of 1973 level)

Source: Center on Budget and Policy Priorities

**Figure 2: Cost of borrowing and return on capital, for UK non-financial companies**

Data source: Thomson Reuters Datastream

“As political economy overrides the ‘new normal’, the policy box is set to explode, bringing a reordering of policy priorities.”

Dr Peter Warburton is Director of Economic Perspectives and Managing Director of Halkin Services.