MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Interest Rate Boomerang: Does It Matter?

As shown on the following page, long-term interest rates in the US have been falling, irregularly, for almost 40 years. After the Federal Reserve successfully broke the upward spiral of inflation in the late 1970s via extraordinarily tight monetary policy, bonds became viable and rewarding investments year after year. The trend is so well-established that only a small minority of investors or portfolio managers actually have any personal experience with an extended period of rising interest rates or inflation.

Last year, rates on 10-year US Treasury securities dropped to their lowest levels in modern history, just below 0.4%. Rates remained unusually low during the worst of the pandemic period due to the collapse in economic activity last spring, and to the Fed's campaign to brunt the impact of the recession with its maximally aggressive easing of monetary policy. But while some important sectors (mainly travel, leisure, hospitality, and the like) remain under pressure, by a host of measures the economy has either fully recovered or is on the verge of doing so in 2021. With the advent of successful vaccines, only the timing of such a strong recovery was ever in question, as we have discussed previously in *Consilium*.

If last year's drop in rates was due to the pandemic, and the economic effects of the pandemic are ending, it really cannot be surprising that rates have risen back to their pre-pandemic levels, for the very best and most obvious of reasons. But again, referring to the chart on the following page, does this mean that the 40-year trend of declining rates is over? Is it a given that what must follow next is many years of rising rates? It is absolutely *not* obvious! One can clearly identify numerous "false starts" when the trend appeared set to reverse, before reasserting itself. Can we be certain of the outcome this time?

We cannot, because the path for interest rates depends on whether the years ahead will be characterized by strong growth and moderate inflation, strong growth and higher inflation, or a brief period of higher growth and inflation before returning to recent trends.

It is true that inflation looks set to move somewhat higher, but for an indeterminate period. Part of this is simply due to "base effects", that is, the very low starting point for consumer prices today. But the Fed appears particularly determined to ensure that inflation returns to its long-run target of 2% and will not risk resuming a neutral monetary policy until full employment has been restored, and it is convinced that any deflationary impulse in the economy has been vanquished. Along with record financial system liquidity, tremendous pent-up demand, and unprecedented fiscal stimulus proposed by President Biden, there are good arguments that the Fed's approach sets us on a path to meaningfully higher inflation than we have experienced in decades.

But it may not be that simple. Pent-up demand, once released, will not repeat itself. Cash reserves will be depleted once the opportunity exists. Stimulus programs of the type being proposed have proven repeatedly to have disappointing "multiplier" effects – i.e., the benefit of the spending does not last far beyond the period during which the spending occurs. And this is before consideration of the corporate and personal income tax increases the President has promised, whose effect will be much longer-lived.

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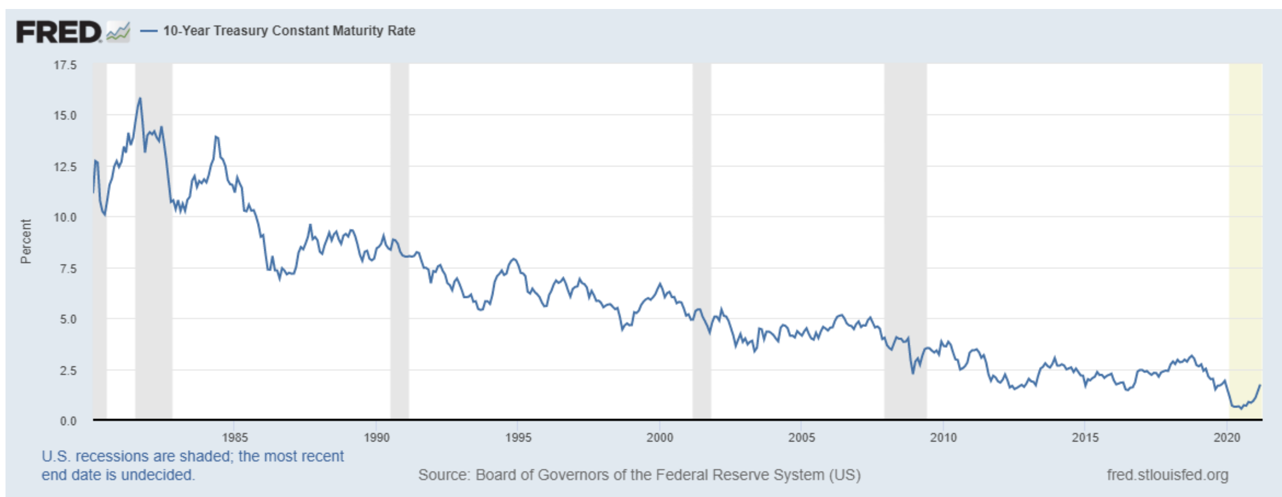
However important these factors might be over the next few years, it is critical to note that the path of interest rates has generally followed the path of nominal GDP growth in a downward direction for decades, owing mainly to demographic factors that are essentially irreversible. We addressed the long-term trend toward slower GDP growth worldwide in our October 2019 issue of *Consilium*. To reiterate, birth rates and population growth rates have fallen dramatically since the postwar baby boom, and there is no evidence that this trend is about to change. In fact, the UN estimates that US population growth, having fallen by half since the 1980s, will fall in half again by 2050.

The other half of the real growth calculation, productivity, has stubbornly refused to perk up as well. Despite our astonishing breakthroughs in technology, helping individuals and businesses do more with less time and effort, we continue to be ever more reliant on our service sector. While the service industries are more stable, they offer little opportunity for productivity gains. Advanced manufacturing processes can turn out more widgets, and faster, but the simple fact is that a lawyer, a dental hygienist, or a hair stylist can only accomplish so much in a given period of time. The broader economy is thereby limited in its productivity potential.

After a strong recovery from the pandemic, then, the most likely path for the economy is a return to moderate growth and inflation. We believe the burden of proof falls on those calling for a new age of sustained, rising inflation and interest rates. It could happen – but it hasn't happened yet. And while this temporary (and welcome) period of economic strength could lead investors to prefer companies with more cyclical characteristics, we believe businesses that are less reliant on a booming economy ultimately will return to favor, and that investors will be rewarded for their patience.



Sources: Federal Reserve Bank of St. Louis; United Nations "World Population Prospects"