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SPECIAL REPORT

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Who's Afraid of Positive Real Interest Rates?

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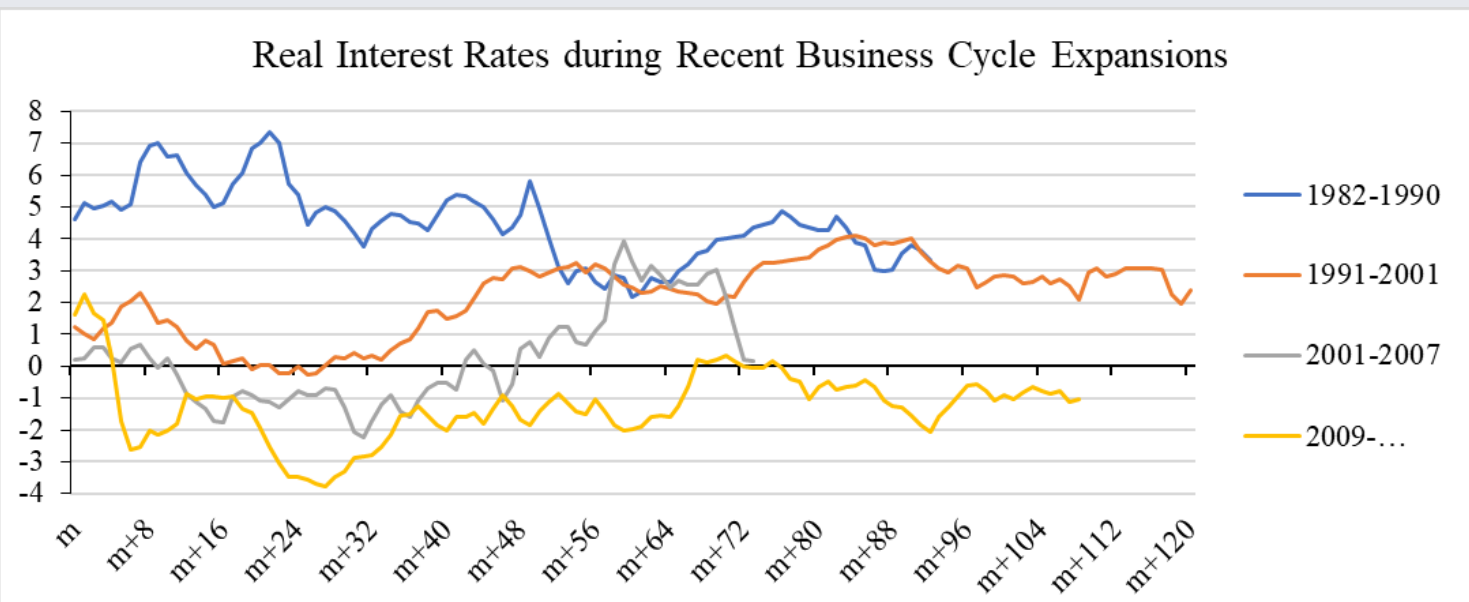
Who's Afraid of Positive Real Interest Rates?

The recent slide in the price of US Treasuries (from a yield of 2.85% in the last week of August 2018, to around 3.20% by mid-October) has potentially cracked the upwardly floating glass bubble in which the equity markets – and asset prices in general – have been riding. The market has seen this sort of price break before, but the reaction – especially in the consumer sector and home mortgages – means this time may be different. But let's start from the beginning, i.e., the Federal Reserve's policy.

Chairman Powell's October 3, 2018 statement that "we are still far away from neutral" (notwithstanding the Federal Reserve's interest rate adjustments in 2018) suggests at least an awareness of how much room the Fed still has for "dis-accommodation" in the context of the level of current real interest rates, a tight labor market and increasing evidence of inflation.

In fact, interest rates are currently too low if one considers macro fundamentals (GDP growth and unemployment rate), asset prices and the resulting distortions in our economy that the suppression of interest rates has created (e.g., the increase in corporate debt by more than $2.5 trillion since 2008, the dangerous preservation of zombie firms, and the spread of morally hazardous behavior among "too-big -to-fail" entities).

Consider the following graph comparing real interest rates (Fed Funds less averaged CPI) across the four recent business cycle expansions. Our current expansion has lasted nearly as long as the 1991-2001 expansion, however we have been in a negative real rate environment for over 85% of the time with no meaningful period of positive real interest rates.



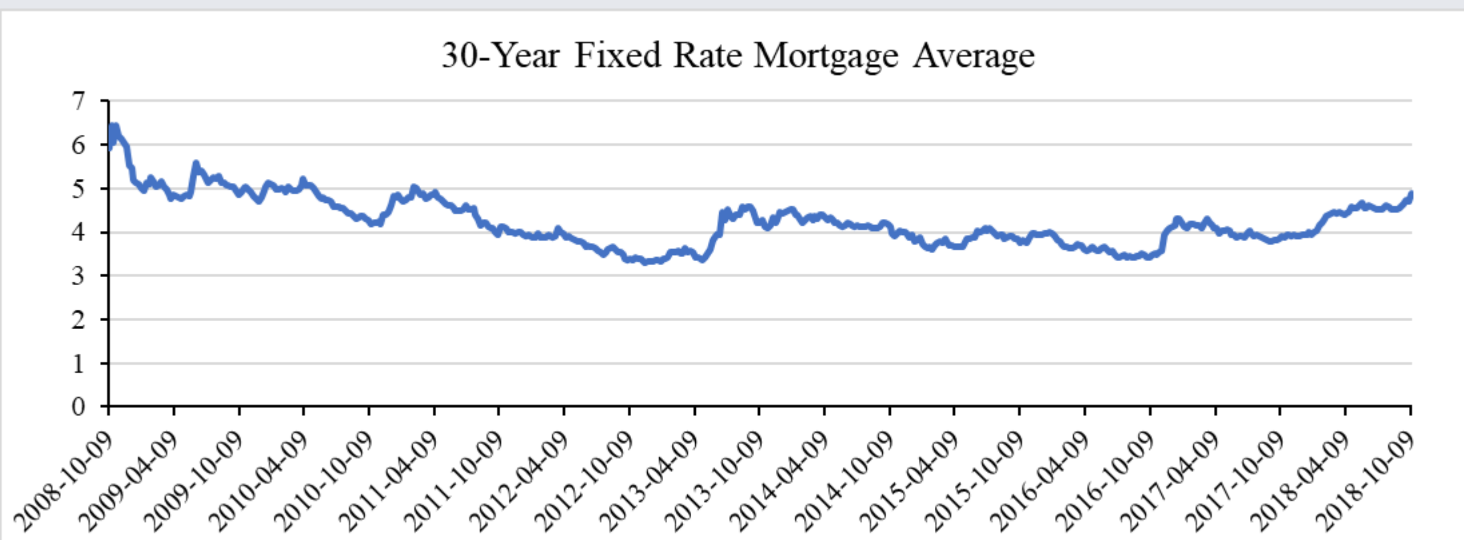
Notes: Authors' calculations.
Effective Federal Fund rates and Consumer Price Index (CPI), monthly data, see https://fred.stlouisfed.org.
Business cycle expansions based on www.nber.org/cycles.html.

What's more, successive recessions have each begun from *lower* real rates, dispelling the notion that we may be insulated from another because real rates are low.

In fact, for the past ten years, the Federal Reserve has feared that the US economy would be unable to sustain positive real interest rates. Its accommodative monetary policy, funneled through its "forward guidance" strategy, was aimed at avoiding market disruption. The extended period of artificially low Federal Fund rates and consequently low real interest rates has allowed institutional memories to fade while the new cohort of managers and more senior executives have assumed responsibility without meaningful experience in an environment of positive real rates. In this new era where financial repression has become the "new normal", how will investors react to the necessary gradual interest rate hikes that are looming on the horizon?

These contradictions – the inability to sustain growth sufficient to warrant positive real interest rates even as asset prices have drifted ever higher, the use and reliance on debt that has exploded to unimaginable levels, and the continuing shift in financial transaction activity further away from longer term investment as it structurally adapts to near zero and negative real rates – suggests that the Federal Reserve and the regulators may need to prepare for a deleverage shock.

Howsoever flawed as a measure of inflation, the upturn in the CPI over the past 3 years will need to be kept in focus. With home mortgage rates crossing above 5% (see below), and with corporate and student loan debt growing geometrically, the Fed faces a challenging balancing act.



Notes: 30-year fixed rate mortgage average in the United States, percent, weekly, not seasonally adjusted, see https://fred.stlouisfed.org

About Authors:

Norbert Gaillard is an economist and independent consultant (www.norbertgaillard.com). His main areas of expertise are public debt, sovereign risk, country risk, and credit rating agencies. He has written more than 20 research articles and published three books since 2010.

Richard J. Michalek is a New York-based independent legal and financial consultant. He has consulted on a number of complex structured derivative litigation matters, and continues to consult hedge funds, private equity investors and government agencies on matters relating to the rating agencies and their processes.

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