

## Real Interest Rate Paradoxes

The concept of a “real” or inflation-free, interest rate is another one of those things in finance where we are forced to measure an absolute price with a set of relative yardsticks. In this regard it is similar to currencies, where one is termed strong or weak in relation to another regardless of whether both are falling in relation to an absolute measure such as gold. Worse, as the entire purpose of an interest rate at any maturity is to equilibrate future consumption to present consumption, the exercise teeters on the edge of pointlessness. After all, the decision whether to spend a dollar now or save it to spend later must be based on some estimation of what real purchasing power will be in the future. Inflation expectations along with both interest rate and currency volatility are a required input to that calculation.

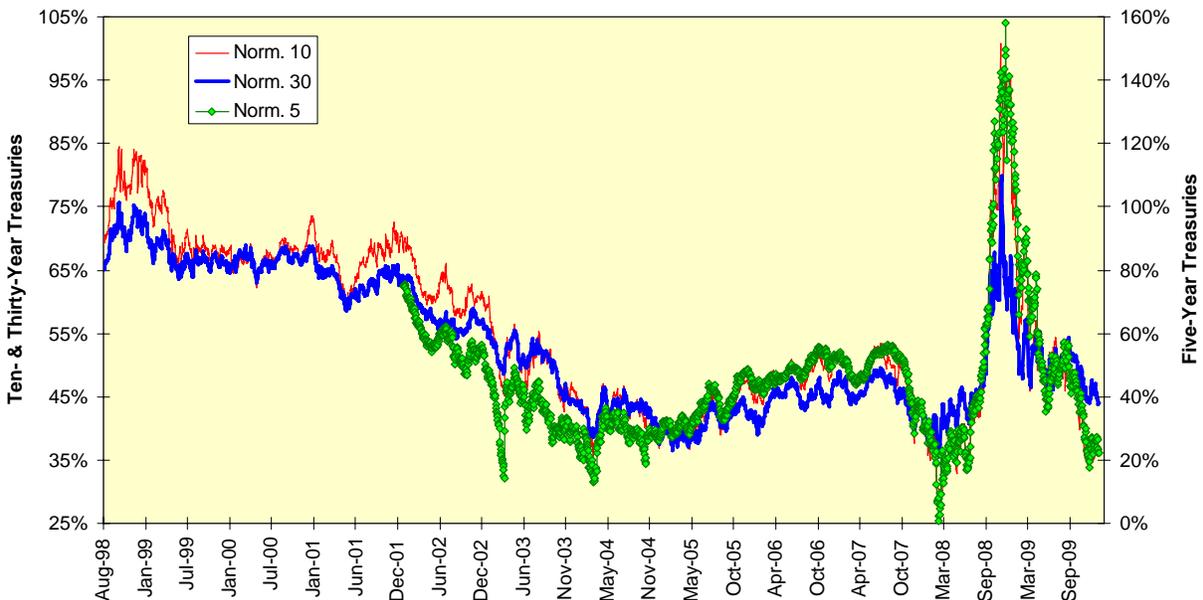
As all inflation measures are imperfect – central bankers ignore the price of assets in their calculations while they focus on the measured price of assorted baskets of goods – and as real interest rates themselves are shifting constantly under factors as diverse as the shape of the yield curve, changes in the supply/demand balance for credit and the demand for “crash insurance” in the conventional Treasury market, we should view all attempts to reconstruct nominal interest rates as the sum of some constant real rate plus an expected rate of inflation with a grain of salt, as discussed in [October 2003](#).

However, all relationships in finance are information-rich. If we subtract TIPS breakeven rates of inflation from nominal interest rates to proxy for a real interest rate and track the ratio of this real rate to the nominal rate over time, we should, as suggested last [Friday](#), be able to learn something about the supply/demand balance for credit and therefore about the balance between economic activity and the state of the financial markets.

### Normalized Real Interest Rates

If we map the history of  $[(\text{nominal rates} - \text{TIPS breakevens})/\text{nominal rates}]$  for the five-, ten- and thirty-year maturities, we see how normalized real rates declined between early 2002 and the March 2003, then rose into September 2007, fell again into March 2008, exploded higher during the financial crisis and have been declining since the Federal Reserve cut the target federal funds rate in December 2008.

Ratio Of Real To Nominal Interest Rates

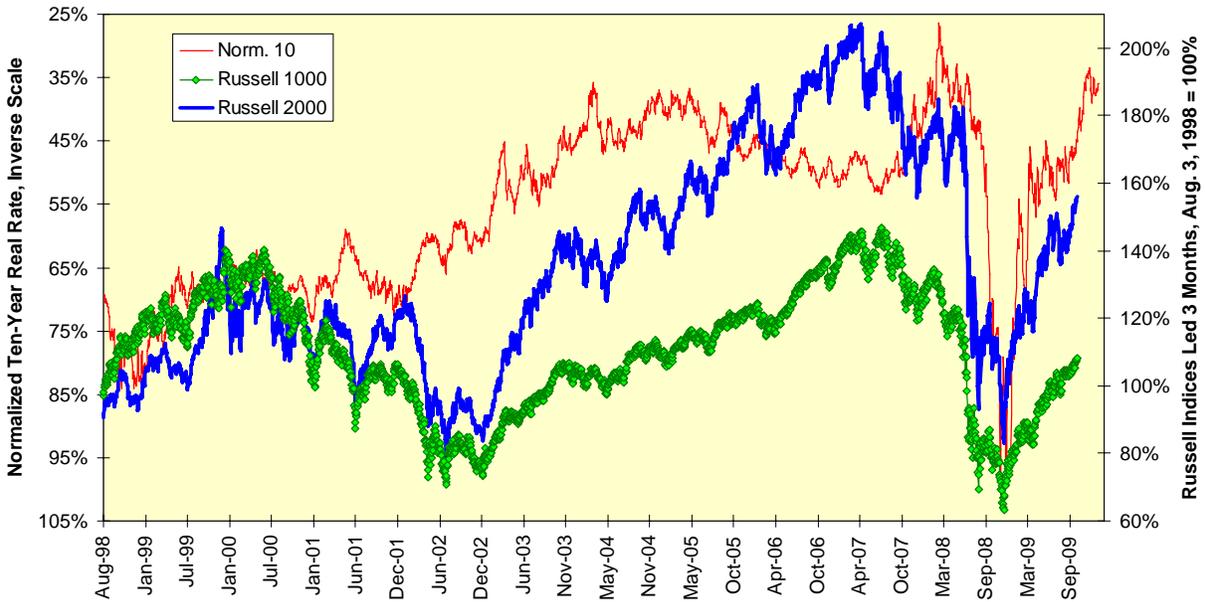


### Stock Market Impact

The present environment is characterized by declining real rates relative to nominal rates. This indicates increasing availability of credit relative to demand and rising inflation expectations. We saw this combination during the later stages of the 2002 bear market and for the six months between the October 2007 nominal high in stock prices and the Bear Stearns low of March 2008.

This sounds like a bad combination, but is it? Let's isolate the ten-year rate normalized real rate from the above and plot it inversely against U.S. large- and small-capitalization issues as measured by the Russell 1000 and Russell 2000 indices, respectively. The normalized real rate measure led the stock indices by three months on average during each of the three environments noted above. This is consistent with the argument the stock market rally is being propelled by liquidity: Low interest rates and rising inflation expectations lower the real cost of capital and encourage risk-taking.

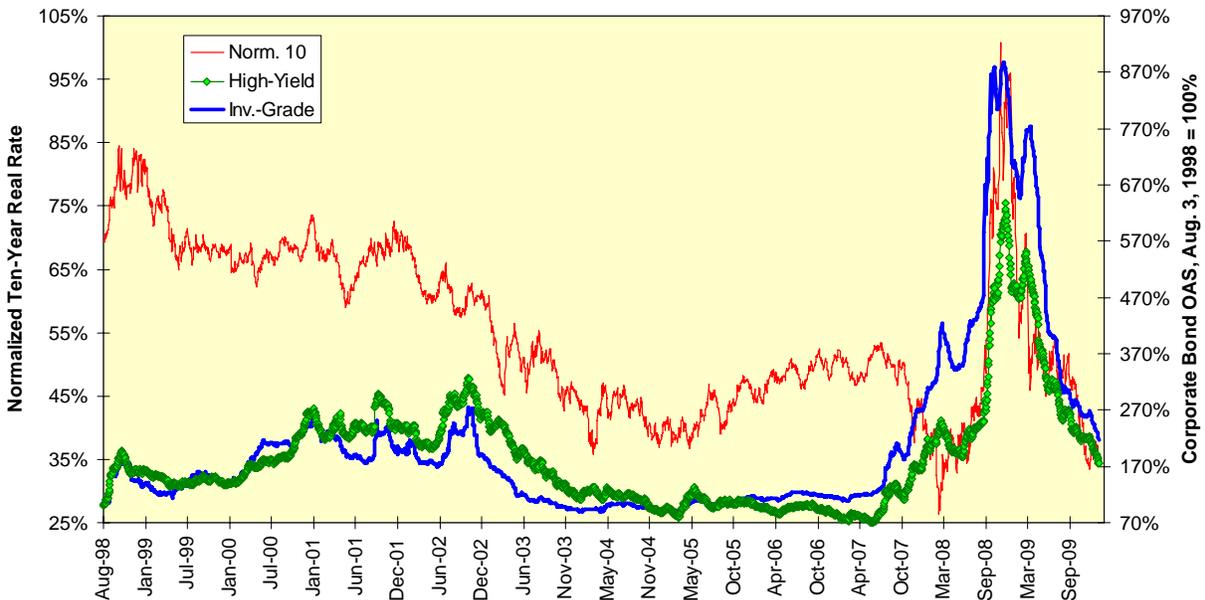
### Stock Market Impact



### Corporate Bond Market Confirmation

As the last year has been rewarding for corporate bond investors, too, let's repeat the exercise above for the option-adjusted spreads for investment-grade and high-yield corporate bonds. Here the answer is strikingly clear: The rise-and-fall of corporate credit spreads is matched directly to real interest rates and inflation expectations.

### Bond Market Impact



The risk of such a direct connection is obvious. Should the supply/demand balance for credit be restored via a combination of increased private credit demand and an end to monetary stimulus, corporate bond spreads will stop contracting virtually immediately and stocks should peak approximately three months afterwards.

### **Now What?**

We all know that day will happen again within our lifetimes, but the question becomes, “When?” If last Friday’s report of a massive \$17.494 billion drop in consumer credit in November is any indication, lower interest rates alone have not led to increased credit demand even though retail sales during the Christmas season were surprisingly strong. Commercial and industrial loans are still 16.5% below year-ago levels.

Only public sector borrowing is increasing. That shift in credit demand goes a long way toward explaining the poor employment situation and why monetary stimulus has yet to ignite price inflation: The credit being transferred to the public sector does not lead to net job creation, no apologies offered to the fantasists who believe in the “[jobs created or saved](#)” nonsense, and it does not lead to expansion of the money supply through the fractional reserve lending mechanism.

This policy mix can continue for as long as there is either an external financing source or enough ink for the printing presses. The odd outcome, seen in the reaction to last Friday’s unemployment report, is a weak economic outlook will support low real interest rates and strong financial markets. Can Wall Street outrun Main Street forever, especially in light of continuing popular anger over the bailouts and Bonus Bogarts? No; at some point expect some very re-distributionist tax policies.

Finally, if the real economy starts to demand additional credit and the printing presses stop to avoid inflation, watch out for a sudden jump in real interest rates and a sudden downturn in the corporate bond market. And then cease to negotiate: Then and only then will this rally be threatened.