

Are Those Rates Real?

If you wish to get seated at a crowded restaurant, start talking in a can-be-heard voice about real interest rates. The place will clear out in no time and you will get your choice of tables unless the American Economics Association is in town. Then they will invite you to sit down and share a few thoughts; notice how nothing was said about them buying you dinner.

The subject should be anything but dry and unimportant. As we shall see below, the mix between inflation expectations and real interest rates affects what exposure you should have to risky assets, including corporate bonds and stocks.

It Is Of Interest

The simple fact of the matter is few subjects are as important to the allocation of resources within an economy and are as difficult to assess in practice as real interest rates. Interest rates are the price of money; that much is quick and simple. But in their economic sense, they equilibrate future and present consumption. If they rise, consumers have an incentive to save and defer consumption until later; if they fall, consumers lose their some of their incentive to save. That is a “some,” not an “all:” As interest income falls, people have to save an ever-greater percentage of their paychecks to meet retirement or other goals (see “To Save or Not to Save,” November 2008).

We now have to bring inflation expectations into the mix. It is one thing to recite Fisher’s Law robotically, that nominal interest rates are the sum of real interest rates plus expected inflation, but it is another thing to get some hard numbers. Economists had hoped to use the breakeven rates of inflation from the Treasury Inflation-Protected Securities, or TIPS, market, but those breakeven rates can be distorted by flights to quality to financial crashes, by investment flows, by changing expectations of tax rates and by skepticism over the government’s reports on consumer inflation. It has not been difficult at all to write why the TIPS market is flawed (see “The Illusion of TIPS Protection” and “Are You Throwing Your Money Away,” May 2007 and December 2008, respectively).

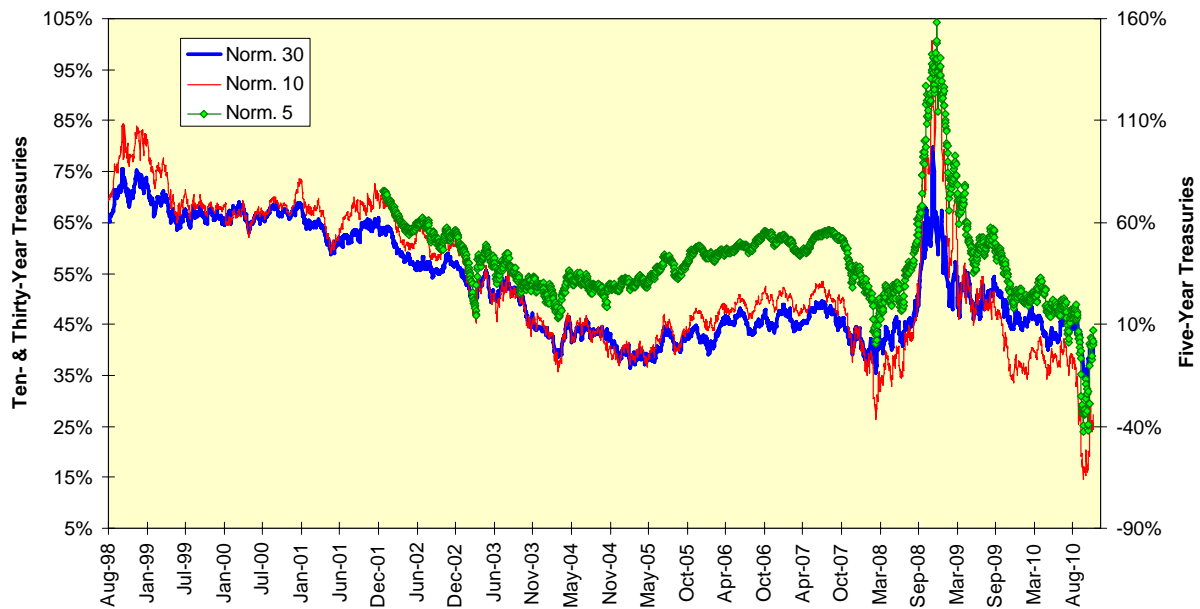
If Fisher’s Law worked in this market, you should be able to run it backwards by taking known nominal interest rates and known contemporaneous TIPS breakevens and derive known short-term interest rates. That you cannot do so tells you other factors, including the volatility of both interest rate and currency markets, the shape of the yield curve and swap spreads, or the willingness of floating-rate borrowers to fix their payments, enter into the equation.

Let’s not let the best be the enemy of the good. All relationships in finance, even the imperfect ones, 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 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

As interest rates have varied wildly over most our lifetimes, from near 20% short-term levels in the early 1980s to near-0% short-term levels starting in 2008, we should focus on relative measures to normalize real interest rates. Let’s create a measure called normalized real interest rates, $[(\text{nominal rates} - \text{TIPS breakevens})/\text{nominal rates}]$ to do this. These are displayed in Chart 1 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 declined sharply between the time when the Federal Reserve cut the target federal funds rate in December 2008 and when it began its second round of money-printing (quantitative easing) in November 2010.

Chart 1: The Real / Nominal Rate Ratio



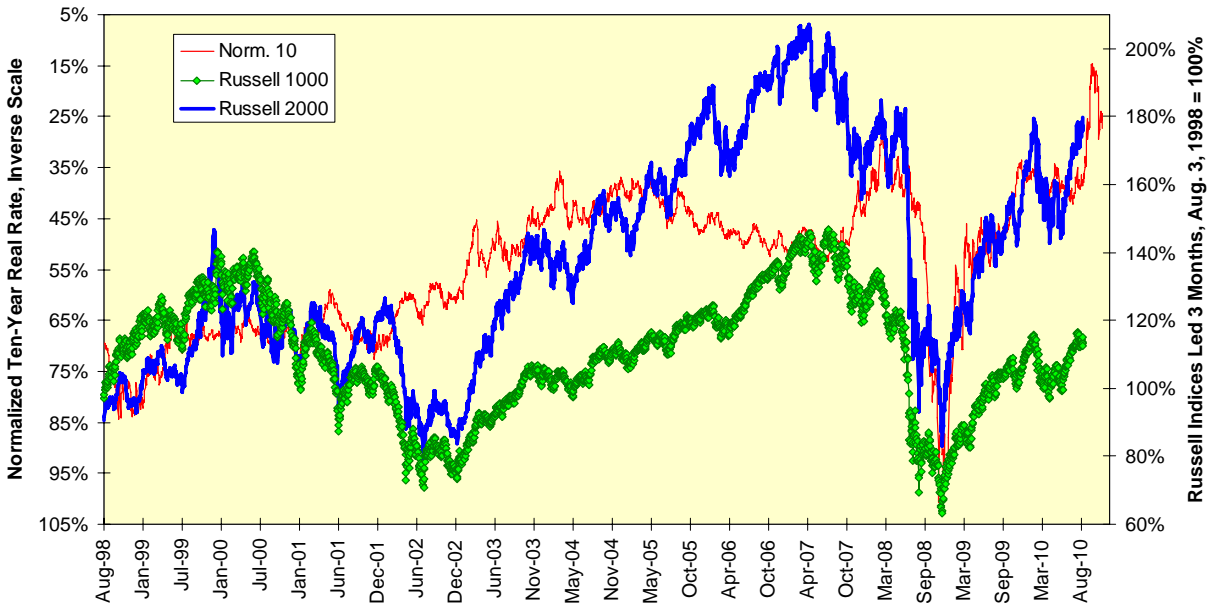
As the three measures move together closely and as the weighted average maturity of most broad corporate bond indices is close to ten years, we can isolate the normalized real ten-year rate in the remainder of the discussion.

Taking Stock

What does a period of declining real rates relative to nominal rates indicate? By definition, a falling level of real interest rates signals increased availability of credit relative to its demand. A falling ratio also can signal rising inflation expectations. We saw this combination during the later stages of the 2002 bear market and for the six month period bracketed by the October 2007 all-time high and the March 2008 Bear Stearns panic low.

Falling credit demand and rising inflation expectations sound like a bad combination. Is it? If we plot the normalized ten-year real rate in Chart 2 inversely against U.S. large- and small-capitalization issues as measured by the Russell 1000 and Russell 2000 indices, we see it led the stock indices by three months on average during each of the three market environments noted above. This is consistent, incidentally, with the argument the corporate bond and stock market rallies of 2009 were propelled by liquidity: Low interest rates and rising inflation expectations lower the real cost of capital and encourage risk-taking.

Chart 2: Normalized Real Rates' Stock Market Impact

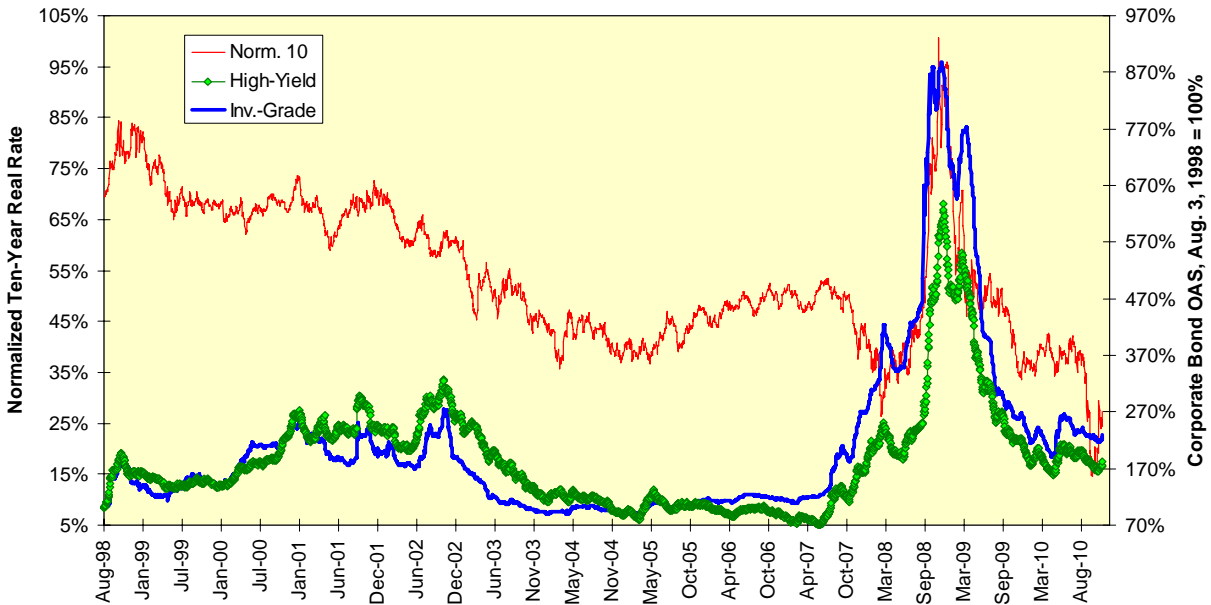


What About Corporate Bonds?

Corporate bonds led stocks out of the 2008 market panic; indeed, investment-grade and high-yield bonds hit their bottoms on November 20 and December 16, 2008, respectively. Stocks did not hit their low until March 9, 2009, and investors in high-yield outperformed almost all classes of American stocks for the calendar year of 2009 and through November 2010.

Corporate bonds lost their Rodney Dangerfield status during this period: They got respect, maybe even a little too much respect. Regardless, if we map the normalized real rates for ten-year notes and plot them inversely in Chart 3 against the option-adjusted spreads for investment-grade and high-yield corporate bonds, a clear answer emerges: The rise-and-fall of corporate credit spreads is matched directly to real interest rates and inflation expectations.

Chart 3: Normalized Real Rates' Corporate Bond Market Impact



We can state a rather definitive conclusion: The risk of such a direct connection between normalized real rates and the health of the corporate bond market is obvious. Once private credit demands increase relative to government credit demand, a more normal price of money should reemerge. If coupled with an end to excessively loose

monetary policies, the best-of-all-worlds markets of 2009-2010 will start to disappear just as a similar market in 2003 dissipated. We will see a higher normalized real interest rate, and that should end the contraction of corporate bond spreads as seen in Chart 3. In addition, as the three-month lead time shown in Chart 2 indicates, an end to the corporate bond rally should lead to an end in the stock market rally about three months later.

The End Of (Recent) History

One of the enduring legacies of the Great Recession has been and will be a break in the pact between what have been termed Wall Street and Main Street (see “Wall Street Armageddon,” January 2009); this distinction can be lost to those who live on both. Social compacts had arisen after World War II: Your home was your best investment, long-term investors were rewarded for their patience and if you played by the rules, this was the greatest place on earth. Those assumptions were shattered over the past decade as housing prices fell, two bear markets punished long-term and stock-heavy investors, the government moved to bail out those who had perpetrated the distress at the cost of the innocent.

The rising federal debt load started to crowd out private credit demands in 2008, and the bailed-out banks started to gorge on the steep yield curve to finance the government’s deficits at the expense of job-creating private borrowers. This is what pushed real interest rates lower and pushed inflation expectations higher. The final irony was the chief beneficiaries of this twist in policy results during 2009 were those very same financial institutions seen at the fire with a book of matches and a can of gasoline.

Once this strange mixture of economic distortions ends – if it ends (see “A Tale of Two Tragedies,” September 2008) – the real economy will recover at the expense of investors and financial games. This will be a time of mixed emotions for investors used to gorging on government malfeasance. Investors, a class likely to include you, should be careful for what they wish.