INTEREST RATES

Where are interest rates today?

The 5-, 10-, and 30-year U.S. Treasury bonds are paying 2.9%, 2.8%, and 2.9%, respectively. In contrast, inflation-protected bonds issued by the U.S. Government (TIPS bonds) are paying less . . . the 10-, 20-, and 30-year TIPS bonds are yielding just -0.1%, 0.3%, and 0.3%, respectively. No, that's not a typo, the 10-year TIPS bond is actually "paying" a negative interest rate (i.e., -0.1%). In other words, you pay the government instead of them paying you. So, if you've got TIPS bonds in your investment account, ask your financial planner why.

Are interest rates *"high"* or are they *"low"*?

To answer this question, consider a simple example. Consider the 5-year U.S. Treasury bond. It currently yields 2.9%. If your marginal tax rate is 37 ½% (for combined state and federal taxes), then you're left with 1.8% after paying taxes on this bond. The market is currently forecasting that inflation will average 3.3% over the next 5 years. Therefore the 5-year Treasury bond is currently priced to provide you with a negative return of -1.5% per year, every year, for the next 5 years (after inflation and taxes). Most investors would conclude, based on these observations, that interest rates are crazy low.

How did interest rates get this low?

Interest rates this low have happened before and will happen again. But it's not easy to get to such an extreme level. Economists are in agreement on the six factors that drove interest rates to this bizarre level, but are in disagreement as to the weight that should be assigned to each. The six factors are:

- Seriously slow economic growth (over the last 20 years)
- Lack of attractive investment opportunities for businesses (they can't find anything worthwhile to invest in)
- Monetary stimulus by the Federal Reserve (they've been printing money)
- Collapsing international trade
- Falling inflation (until just recently)
- People have been very slow to adjust . . . very slow to realize that they're losing money each and every year after adjustment for taxes and inflation (individuals are still playing catchup)

What happens to interest rates next?

They go up. They go up a lot. And this rise is not over 2 or 3 or 4 years . . . instead, it's over 2 or 3 or 4 decades. Please appreciate that such an outcome is not the exception, instead it's exactly what's historically commonplace and normal. If interest rates were to rise for just a year, or two, or three . . . that would be abnormal and inconsistent with history. Will interest rates rise each and every year? Of course not. They have never done so. Instead, we will experience wiggles all along the way.

SIDE NOTE - No, the Federal Reserve does not set or control interest rates. Such suggestions are just nonsense that one sees all too often in sensationalist articles or product advertisements.

Why is it necessary that interest rates rise?

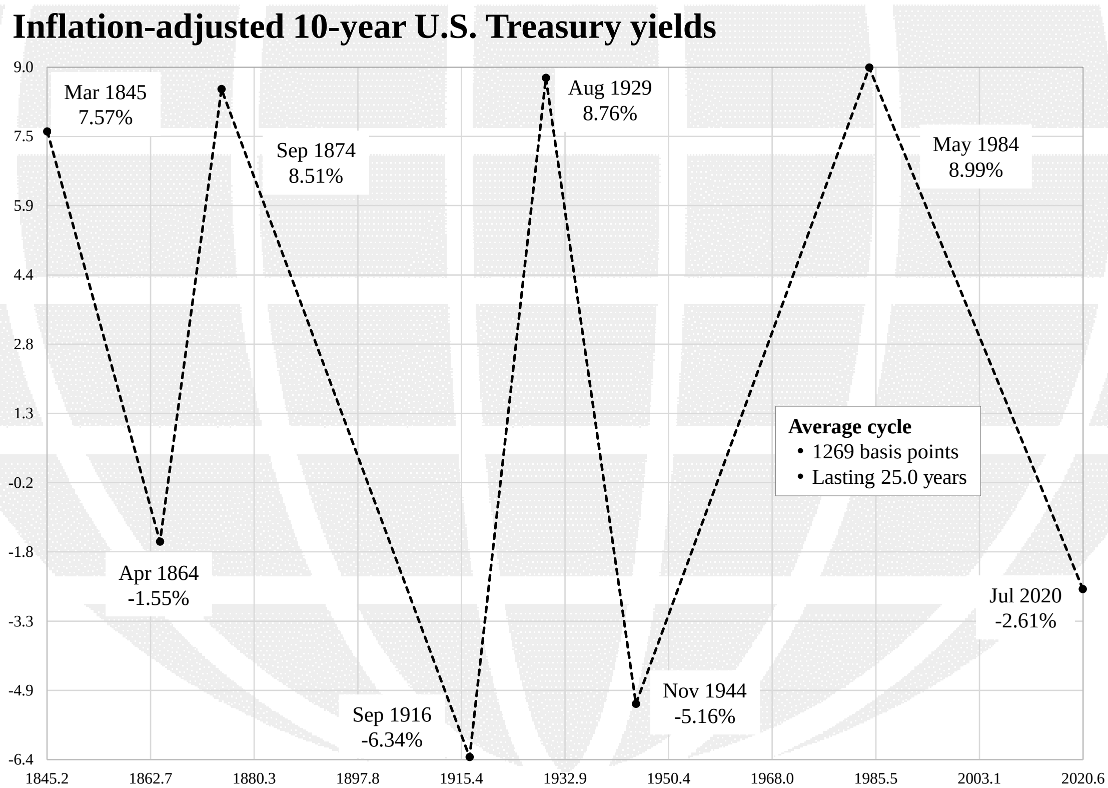
Because people don't lend money with the objective of losing money. Negative interest rates (which is what we have today) can last for quite a few years, but not indefinitely. When you lend money, you:

- Give up the use of that money
- Suffer from illiquidity
- Expose yourself to various risks (e.g., default, inflation, interest rate, currency)

People require a large enough return to fully offset these three disadvantages. People are not permanently irrational. Eventually, they will stop lending their money . . . until such time as interest rates rise sufficiently to return a fair (if modest) return.

What's normal for interest rates - what's always happened throughout history?

They rise or fall by 12% to 13% over 25-year periods. The following graphic shows the history of interest rates after adjustment for inflation. Two- to three-decade long cycles of rising or falling interest rates is the norm.



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What would be abnormal and seriously peculiar?

The 10-year Treasury yield stays at its current level of 2.8% . . . which after taxes and inflation is losing -1.2% per year, every year, for ten solid years. Such an outcome is just not sustainable. Equally abnormal would be for interest rates to fail to overshoot, they always have in the past. In other words, they always rise too high and similarly fall too low. Consider the graphic above.

Conclusion

So why is this important? Because bonds are a critical component of any successful investment program. As the above graphic identifies, interest rates (after adjustment for inflation) have been falling since early-1984. But now we've embarked on what is likely to be a multi-decade long era of rising interest rates. And bonds behave very very differently during a rising interest rate environment than during the past falling rate environment.

Your financial advisor has a menu of possible investment solutions that are directly relevant to these perils. But the solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

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