

SmartRamps Commentary, January 2012

It was the best of times, it was the worst of times

It was the age of volatility, it was the age of tranquility, it was the epoch of financial disasters, it was the epoch of financial stability. With apologies to Dickens, that sentiment well summarizes both the last year in financial markets and the next year in financial markets. The euro's continued very existence is being cast into question as Greece, Ireland, Portugal and Italy all experience financial crises. The global supply chain is challenged by events like Japan's tsunami and nuclear catastrophe and Thailand's flooding. China moves up to the world's number two GDP but is threatened by the same type of housing bubble that torpedoed the U.S. economy. And in the U.S. we see Congress lurching from self-inflicted crisis to self-inflicted crisis. S&P downgrades U.S. debt; the sovereign debt of many European nations is under a credit watch; and the financial strength of many large European financial institutions is being questioned.

And with all this financial stress, what is happening to interest rates? In a word: nothing!

It is common knowledge that interest rates were at historic lows in throughout 2011. For example, before the 2008 financial crisis, the one year Treasury rate's lowest daily value was 0.88 percent in mid-2003. At the very end of 2008, at the height of the financial crisis, the one year Treasury rate dropped to 0.34. In contrast, in 2011 the highest daily value of the one year Treasury rate was 0.31 percent and it dropped as low as 0.08 percent and averaged 0.18 percent.

Equally noteworthy although not commonly mentioned, is how resistant U.S. interest rates were to change despite a series of serious economic shocks as well as policy interventions like Operation Twist. For example, the one year Treasury rate had a range of only 23 basis points. Until 2010, the minimum range had been 50 basis points, and since 1970 the mean range had been 2.47 percent. While the mean may be biased upward due to periods of rising or falling rates, even the median minimum range is 2.19 percent. That interest rates were at historic lows in the U.S. should not be a surprise. That interest rates had historic levels of stability has been a surprise for many.

What do these patterns suggest for the future? Given the range of shocks to the economy and the continuing threat of a global recession, it is difficult to conceive of a high-probability event that would dramatically change the Federal Reserve's objectives in the coming year. Certainly if the U.S. economy were to substantially pick up, it would not be surprising to see the Fed tighten monetary policy and interest rates to rise. However, that outcome should be viewed as a relatively low probability, event for at least three reasons.

First, the European economic situation remains in flux. The proposed economic tightening is more likely to lead to contraction rather than expansion, with a higher probability of Europe re-entering a recession rather than experiencing an increase in growth. Such a scenario would make strong U.S. growth less likely.

Second, even with strong U.S. growth, the U.S. unemployment rate is likely to remain very high by historic standards. It would appear unlikely that the Fed would slow money growth as long as the unemployment rate remains above 8 percent.

Third, the fundamental reason the Fed increased money growth (or more precisely growth in the monetary base) so dramatically was an unprecedented increase in the demand for liquid assets. This change is dramatically illustrated by the unprecedented drop in the velocity of money (M2) falling from about 1.9 prior to the recent recession to a historic low of 1.6 currently. That velocity continues to fall suggests that demand for liquid assets continues to increase and makes any contraction of the money stock or money growth much more problematic.

The message? In terms of the likely path of interest rates over the next year, more of the same with low rates and low volatility appears to be in the cards. Increasing interest rates or more volatile interest rates both appear to be very low probability events.

It is also worth noting the implications of the above conditions for inflation. Many in the business press and even some economists have been loudly sounding the alarm that higher inflation - or dramatically higher inflation - will soon be upon us due to the extremely large growth in the monetary base and the resulting low interest rates. Again, that argument cannot be totally dismissed but it should be seen as an extremely low probability event.

Why? Slow economic growth, a high unemployment rate, and a very high demand for liquid assets, all noted above, place great downward pressure on prices. Another piece of evidence lies in the relation between nominal and real interest rates. Nominal Treasury rates are the typically quoted rates. The current five year nominal Treasury rate is 0.83 percent while the ten year rate is 1.89 percent. In contrast, the current five year real Treasury rate is -0.76 percent while the ten year rate is -0.07 percent. (Yes, real rates can be negative and the real rate refers to Treasury inflation protected securities, TIPS.) The spread between these two rates, the nominal minus the real rate, represents financial markets' expectations of the rate of inflation over the relevant period. So over a five year window, this spread indicates that financial market participants expect a 1.59 percent rate of inflation ($0.83 - (-0.76)$), and over a ten year window, financial market participants expect a 1.96 percent rate of inflation. Those are low numbers, not predictors of extreme inflation.

If someone believed that inflation was going to dramatically increase, they should be buying TIPS and selling regular Treasury bonds. For example, with an actual rate of inflation of say 6 percent over the next five years, the TIPS held would provide a yield of 5.24 percent and the regular bond shorted would yield 0.83 percent, for a net margin of 4.41 percent (given the 6% inflation and excluding transactions costs). A question to ask the pundits predicting sharply higher inflation: How much do you hold in TIPS versus regular Treasury bonds?

My personal outlook for 2012? It is likely to remain the best of times and the worst of times, the age of volatility and the age of tranquility. While another string of economic crises is very likely, interest rates are likely to remain low and stable and the same for inflation.

*Richard G. Sheehan, Ph.D.
Senior Vice President, Research*