Inflation And Interests Rates
Not Two Sides Of The Same Coin But Two Variables In A Differential Equation

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Predicting the economy in general and interest rates always is tricky[1]. One well known economist was famous for saying "Give them a number [interest rate] or give them a date, but not both."

Are interest rates going to go up? Yes. Governments around the world have flooded the global economy with cash for the past several years and the cash printing has become a tsunami over the past 24-months. Further, looking forward, the rate of the money printing is not slowing and will, more likely than not, increase for the next few years. Inflation is simple; it occurs when there is too much money chasing too few goods. For well over a year now, an extraordinary percentage of the world's production capacity has been idled, while governments continue their massive "recovery" spending. So, with stockpiles depleted and production ramping up only slowly, post-pandemic inflationary pressures are inevitable. For example, Intel has reported it could be three years before their production and inventory levels are back to pre-pandemic levels, leaving manufacturers, from auto makers to cell phones artificially constrained in their own recovery. Obviously, constraints of that sort ripple through the economy, affecting more industries as they roll through the economy. There was a good recent example on the East coast. During the four or five day period the Colonial pipeline was closed, the company had the logical idea to start shipping gasoline from Texas throughout the Southeast and East coast by tank truck. The problem, as rapidly became apparent, was during the past year many tank trucks had been mothballed because of a lack of demand for gasoline and many truck drivers had been laid-off and had either found other jobs or were benefiting from the government's enhanced long-term unemployment payments. There was no way to quickly reestablish supply lines, no matter how acute the need. The result? Some 70% of gas stations in the affected areas were completely sold out and gas prices were reported as high as $9.99 per gallon.

Why is inflation important in looking at future interest rates? Historically, as inflation has increased beyond the Federal Reserve's target of 2% to 2.5% annually, the Federal Reserve (the "Fed") has increased interest rates, making financial instruments (particularly Treasury bonds) more attractive, so long as the increase in

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interest rates is seen as exceeding the inflation rate. Taking money out of circulation is intended to slow economic activity (from a Keynesian point of view, the same thing can be accomplished by raising taxes).

This is the approach Federal Reserve Chair Paul Volcker used to crush runaway inflation in October of 1979. Volcker's action broke the inflationary climb, but at the cost of the Federal Funds Rate going to 20% in 1980. (The Federal funds rate is the target interest rate set by the Federal Open Market Committee at which at which large commercial banks borrow and lend their excess reserves to each other overnight.) In contrast, when the economy shows material weakness, the first effort the Federal Reserve makes is to lower the Federal Funds Rate to make borrowing more attractive, to boost economic growth. For example, the Federal Reserve lowered the Federal Funds Rate target to a range of 0.00%-0.25% on March 15, 2020, in response to the COVID-19 pandemic. That move failed to stimulate economic growth for two primary reasons (i) the Federal Funds Rate already had been at or near a real rate of "0" for several years previously, and (ii) because of the pandemic and the global shutdowns, economic growth was artificially constrained and virtually at a standstill, no matter how low the borrowing rates – there simply was no demand and no ability to create demand.

Exactly when, how much, and for how long interest rates are likely to increase is a difficult question in this novel post-pandemic economic environment. While inflationary pressures are increasing, the Federal Reserve is under severe pressure to hold short-term interests near "zero" for both political and fiscal reasons. As an example, with the national debt at about $30 trillion and an average interest rate of approximately 2.2%, annual interest payments are approximately $666 billion. Holding the amount of the debt constant (impossible in reality) if interest rates increase by 200 basis points (2%) the annual interest cost almost doubles to $1.26 trillion. This year Federal tax revenues are expected to be approximately $3.8 trillion, and spending, on a current basis, is forecasted to be approximately $5.8 trillion, a 53% deficit. In today's dollars, interest on Federal debt equals approximately 17.5% of Federal Government's total revenues. With all other things remaining equal and a 200 basis point interest rate increase, suddenly that interest payment goes to 35% of the Federal Government's total revenues. The other overhanging issue is that there is no plan to reduce the debt over time. The assumption is that it will continue to grow forever and that the economy will absorb an unlimited amount of deficit spending (including the eventual need to borrow to pay interest) over time.

It appears we are teed up for increased interest rates over time, but the Federal Reserve will use every tool at its disposal to keep the increase as low and as slow as possible, unless unanticipated inflationary pressures threaten to overwhelm a Federal Reserve that over the past ten years has largely emptied its toolbox and may be forced to raise rates higher than it would desire. Overall, we expect a rising interest environment over the next few years, but in a short-term range of approximately 1.5% to 2.5% annually, not likely the debilitating inflation levels of the early 1980s. Generally, we would expect the ten-year benchmark rate to increase approximately 30-40 basis points through the end of 2022, with significant uncertainty-focused volatility in the interim.

Statistical forecasting service Statista forecasts ten-year rates to be 1.41% at year-end 2021, and Jurrien Timmer, director of global macroeconomics at Fidelity Investments recently said "I think yields could push a little higher. So far, they've (got) up to about 1.75%. I have a simple bond model that suggests 2% should be the upper limit." In its March 30, 2021 investment outlook, PIMCO, one of the largest bond funds and generally considered one of the savviest investors in interest rate sensitive sectors said, in pertinent part, "We forecast a strong global recovery in 2021 amid significant fiscal support, accommodative monetary policy, diminishing lockdowns, and accelerating vaccinations. Despite an expected temporary bump in inflation in the coming months, we believe inflation generally will remain below central bank targets over the next one to two years. However, markets may remain focused on inflation risks in the near term contributing to elevated volatility. We see opportunities in COVID-recovery sectors, housing, industrial/aerospace, and select banks and financials. We favor non-agency [direct private mortgages] U.S. mortgages and select other global structured products . . ."

How do we invest in an overall inflationary environment? Historically, real estate investments, particularly residential rental real estate, and office buildings, have been a good inflation hedge as have construction loans. The key to success in an inflationary period is to select projects with strong sponsors, focus on secondary, or even tertiary, markets, maintain a mid-term (3-6 years) investment horizon, and the idea that the investment is intended to be held to maturity and not seen as a trading instrument. Existing properties have the advantage of immediate cash flow and the ability to reset rents periodically to offset the impact of inflation, while construction loans offer the opportunity for higher interest rates and the option of shorter maturities. Both types of investments provide the opportunity to reinvest at even higher rates at maturity, without loss of capital if inflationary pressures persist, and the potential to sell the loan (or equity position) at a profit if interest rates rise then later subside.