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Why Interest Rates Could Move Lower

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Article Background

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One of the major arguments made by supporters of the 'this times it's different' camp is that inflation has finally been wrestled to the ground.

As a result, they feel interest rates will remain low or move still lower. In contrast, skeptics respond by saying that interest rates have touched bottom and have nowhere to go but up.

Jim Jubak, in a June 1998 *Worth* Magazine article makes a compelling argument that U.S. interest rates have actually never been so *high*.

Real interest rates, that is. The real interest rate being the actual interest rate after inflation is taken out. While short-term rates are strongly influenced by the central bank, longer-term interest rates are set by the market.

The most important factor that the market considers is the long-term inflation rate. Investors demand a long-term return, which is higher than expected inflation.

In 1990, the 30-year U.S. Treasury bond was yielding 9.0%, U.S. inflation was 6.0%, making the real interest rate 3.0%. In 1998, the long bond is yielding 6.0% and inflation is 1.4%. The result? A 4.6% real interest rate.

The Canadian experience is not dissimilar. In 1991, long-term Government of Canada bonds were yielding 9.8%, while CPI, the Consumer Price Index, was 5.6%. Today, the same bonds average 5.7%, while inflation is hovering around 1.0%. Thus, real interest rates have gone from 4.2% to 4.7%.

You might note that the real return on long-term government bonds over the last 60 years or so have averaged less than 2%.

For long-term interest rates to move lower, investors have to believe that their painful experiences in the bond markets of the inflationary 1970s won't be repeated.

They have to be convinced of three things; (1) government deficits are a thing of the past; (2) the Asian situation will continue to weigh on North America, and (3) technological advances have resulted in productivity improvements without the usual accompanying inflation pressures. These three factors will reduce the probability of high inflation in the future.

If they are convinced, then the bond markets and, by extension, the stock markets, have lots of life left in them.

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