September 2018

We are going to close out 2018 with a four-part series. The first three parts will review long-term trends that effect all investors. The final piece will review several cornerstone concepts we use that help clients navigate long-term trends. We hope this series will inform investors and encourage them to review their situation, thus being better prepared for the future.

Interest Rates Will Increase

Increasing interest rates affect asset valuations, bond fund returns and relates to inflation expectations. Stock valuations, as measured by price/earnings (P/E) ratios, vary widely over time. Bond rates vary over time as well. The blue line below is the nominal interest rate (before inflation) on the 10-year U.S. Treasury Bond over the past 20 years. The rate peaked at over 6% in 1998 and fell to a low of under 2% in 2011. The gray line is the real

Historic interest rates

10-Year Treasury Constant Maturity Rate
Real Rate (10-Year Treasury - Inflation)
Federal Financial of St. Local Revenue of Labor Statistics

7.00

4.00

1.00

2.00

1.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.00

2.

interest rate (after inflation) for the same bond. The gray line's swing, just like the P/E ratio, has been material over the past 20 years from a high of over 4% in 1998 to a negative figure in both 2008 and 2011.

Over the past several decades the real rate on the 10-year U.S. Treasury Bond averaged 2.2%, much higher than the 2017 ending figure of less than 0.5% (gray line). This implies that the trend for interest rates is higher, even if inflation does not increase. For example, inflation could remain near the current 2% rate and the nominal interest rate could increase from its ending value in 2017 of 2.4%

(blue line) to 4.2% over the next 18 months and the real rate would be at the 2.2% average. In fact, during 2018, the 10-year interest rate has increased to 3.1% while inflation has not picked up much from the 2% figure.

The Congressional Budget Office (CBO) expects the interest rate of the 10-year U.S. Treasury Bond to continue to rise to over 4% in the next few years, resulting in a real rate that is closer to the long-term average.

Rising interest rates matters for several reasons. First, interest costs on the Federal debt will increase, which will increase the deficit. The CBO has included this in their deficit forecasts. Second, interest rates on many types of loans (mortgages and other real estate-based loans) usually increase when the interest rate on the 10-year U.S. Treasury Bond increases. This could negatively affect valuations for housing and other real estate.

Third, at some level, higher interest rates influence stock valuations. Fortunately, history shows this effect does not become material until rates reach 5%. Finally, bond fund returns will be hampered. Their returns will be lowered in the medium term due to rising rates. Once rates stabilize at higher levels, bond funds should be earning 4% per year, which is a reasonable level in a 2% inflation world.

One caveat is that the preceding assumes a smooth transition over the next few years. Markets seldom work that way, usually over-shooting than settling in. This is important because in 18-24 months we might face a period of heightened anxiety and volatility.

For example, if the 10-year U.S. Treasury Bond rises above 5%, this could increase investor concerns about the economy and valuations.

Whether you are a saver, borrower, or an investor in stocks, bonds, or real estate, the trend in interest rates over the next two years to two decades affects you. Given that your situation is unique, we will return to this Paradigm in December when we review the cornerstone concepts. In the meantime, please let us know if you want to discuss this trend further.

The information above is compiled from various news and research sources, The above information is from sources believed to be reliable, but accuracy is not guaranteed. The above is not investment advice and should not be acted upon without first consulting your Investment Advisor, and/or CPA and/or Attorney to determine the specific impact to your situation.