

THE IMPACT REPORT

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Looking Beyond the Fed for Clues on Interest Rates

By W. Michael Cox and Richard Alm

Interest rates set the terms of borrowing and lending, which in turn impact how much consumers buy, the amount businesses invest, the values of stocks and bonds, the business cycle's ups and downs, job prospects, household incomes, exchange rates, and government finances. We could go on, but the list is already long enough to make it clear why just about everyone wants to know whether interest rates will go up or down, how far and how fast.

Most of the time, the Federal Reserve Board's deliberations dominate the discussion of interest rates. Under chairwoman Janet Yellen, the central bank has had a *Groundhog Day* vibe lately, with repeated vows to ratchet up interest rates slowly and deliberately, the pace

depending on growth, employment, wages and other economic vital signs.

The Fed raised the key federal funds rate a quarter-point in the final month of both 2015 and 2016. In February, Yellen told Congress to expect more rate hikes in 2017 and beyond. The central bank has talked about slowly raising the fed funds rate by roughly 2 percentage points over the next two to three years.

Will it follow through? It's not hard to find reasons for doubt.

For starters, inflation will probably remain low, so the Fed won't face a pressing need to raise rates to keep prices stable. In addition, economic growth remains middling, with slack in the labor market. The unemployment rate is low, but largely because workers dropped out

of the labor force after not being able to find jobs. So far, upward pressure on wages has been slight, confirming the labor market isn't tight.

In March, the current economic expansion will hit 93 months, making it the third longest in recorded U.S. history. It would be extremely unusual for the economy to boom this late in the business cycle. More likely, the economy will pick up steam but not grow fast enough to tempt the Fed to tighten.

WHAT DETERMINES RATES

With minor variations, that's been the Fed story for several years now. Rather than parse Yellen's slow and deliberate script, we take a look beyond the central bank for clues on interest rates.

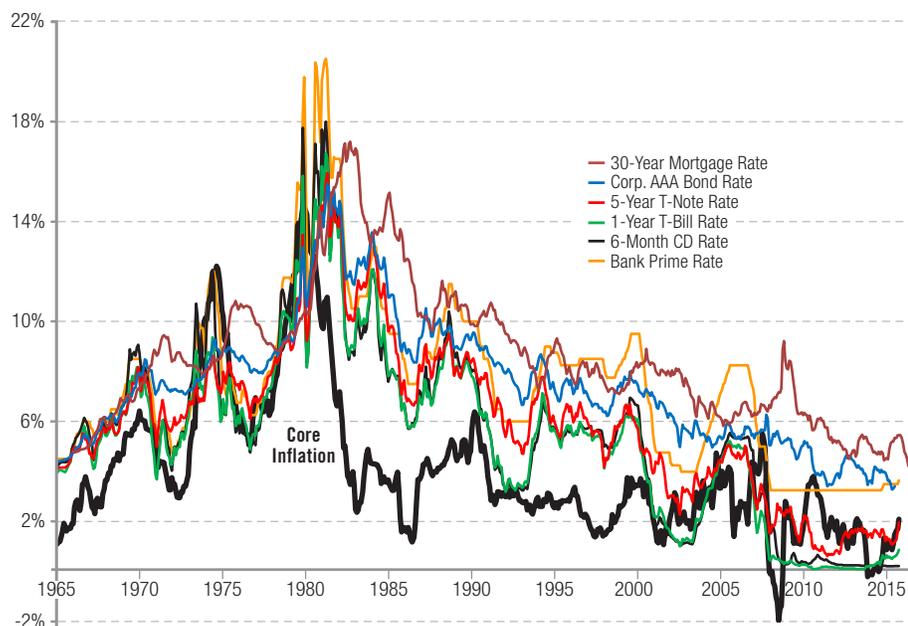
Those looking for a simple answer will be disappointed—there isn't one. In fact, interest rates arise from the interplay of complex economic forces, some of them long-run trends beyond policy-makers' control.

Here's a quick look at key factors that will determine U.S. interest rates:

■ *Expected inflation.* Loan contracts are promises to repay money at some time in the future. Lenders don't want to end up poorer, so they require a premium to protect themselves from the expected decline in money's purchasing power. Market interest rates rise and fall with expected inflation—although not necessarily in lock step (see chart left).

Core inflation, which sets aside volatile food and energy prices, has been relatively low in recent years, finishing 2016 at about

Today's Tame Inflation Helping to Keep Interest Rates Low



Continued on page 2

2 percent. The trend is likely to persist in 2017 and probably beyond. Low inflation will be the most important factor holding interest rates down.

■ *Demand for loans.* Higher loan demand impacts the *real* part of interest rates—i.e., what’s left after subtracting the inflation premium. The demand-driven rate cycle follows a typical pattern: interest rates rising as the economy expands and falling as the economy contracts.

Several aspects of an expanding economy tend to drive up loan demand—for example, businesses that anticipate a growth spurt may seek funding to invest in machinery and equipment to increase output or introduce new production methods. Mortgage rates also tend to rise in good times as higher incomes enable homebuyers to take on more debt. Expansions raise consumers’ demand for credit, pushing up rates on autos, for example. Credit cards rates—already among the highest for consumer borrowing—are affected the least.

■ *Supply of loanable funds.* Among the important drivers are savings rates and asset allocation. As China and other countries with high savings rates joined the global economy over the past 40 years, the supply of loanable funds rose sharply. In the shorter term, the supply of loanable funds could rise if investors decided stocks were too risky and they’d prefer to hold bonds.

Led by China, the developing world continues to generate excess savings. These funds will help keep interest rates low for a quite a while.

■ *The Fed’s visible hand.* Any discussion of the factors influencing interest rates must include the Fed. The central bank’s direct influence on the cost of credit arises from the extremely short-run market for federal funds—the rate banks charge each other for overnight loans. By raising the fed funds rate, the Fed encourages banks to be more parsimonious with their reserves. They lend out less of their deposits (i.e., keep more reserves), restricting the supply of loans to the marketplace and putting upward pressure on interest rates.

Bank lending has been picking up of

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late with improving economic prospects. The activity could have sparked inflation if the Fed hadn’t been engaged in quantitative tightening (QT)—in effect, reversing the quantitative easing (QE) that pumped money into the banking system from 2008 to 2014 (see chart below). Since then, the Fed has pulled about \$775 billion out of the banking system. Excess reserves as a share of deposits have fallen sharply—from a high of 28 percent in 2014 to 17.6 percent this year.

■ *Default risk.* The possibility that borrowers won’t repay loans is a key factor in setting real, or inflation-adjusted, rates. Default risk explains why junk bonds issued by firms with less-than-stellar credit pay higher rates than, say, Treasury securities backed by the U.S. government.

Default risk should ease as economic growth picks up. Some of Trump’s pro-growth proposals—cutting regulation and

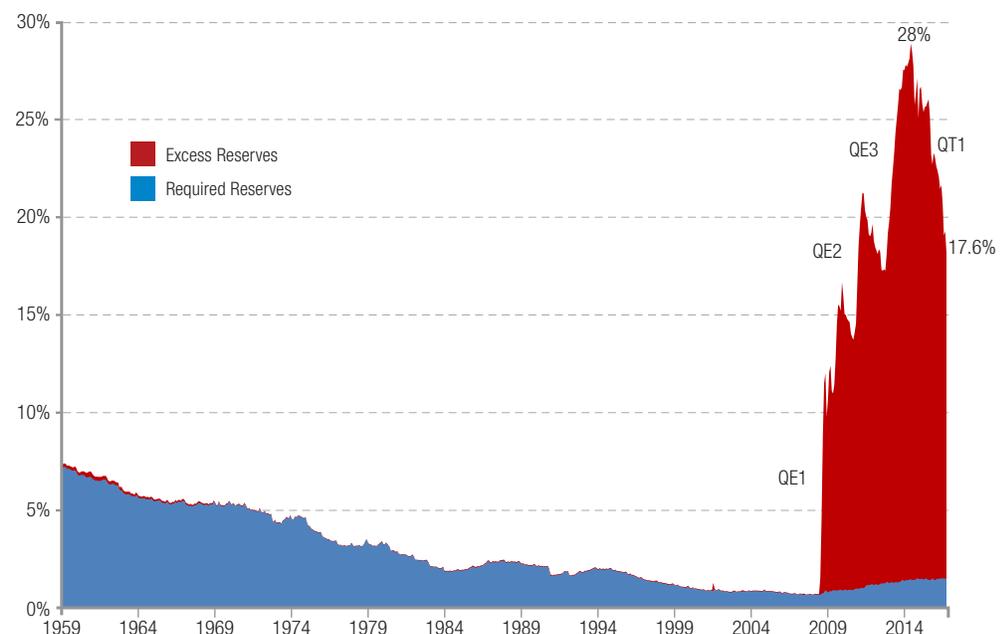
lowering corporate taxes, for example—could reduce the underlying average default risk on loans, helping promote lower interest rates.

■ *Inflation risk.* With inflation stable, the risk of unexpected price increases remains low. When inflation turns volatile, lenders will require a higher inflation-risk premium, putting upward pressure on market interest rates.

With a brief exception in 2005, core inflation has been below 4 percent for more than two decades. So inflation risk would seem low—but some policies contemplated by President Trump, particularly trade protectionism, could increase the odds of an inflationary shock.

■ *Rate risk.* Interest rates may rise or fall before investments mature, creating capital gains or losses. Greater rate risk will require a higher contractual interest

QE in Reverse: Bank Reserves Shrink As Share of Deposits



rate. Looking forward, rate risk is likely to rise as interest rates head up after their nearly decade-long somnolence.

■ *Risk tolerance.* A number of risks affect interest rates—inflation risk, default risk, rate risk and market risk (stock price volatility, e.g.). How they play out will depend on the population’s underlying risk tolerance. Where greater risk is acceptable, investors are more likely to favor stocks and other high-risk/high-yield assets. They’ll need higher returns on safe assets to shift money into relatively low-yielding Treasury securities, CDs and the like.

The United States appears to be going the other way. The Baby Boom generation is reaching retirement age, where people typically shun risk and accept lower rates on relatively safe assets. This will help keep rates low—a trend that will also continue for years.

■ *Tax rates.* Taxing interest earnings reduces the supply of loanable funds; giving tax credits for interest paid raises the demand for loans. Based on campaign promises, taxes are likely to fall under the Trump administration, particularly for higher-income households. Tax cuts should help lower interest rates.

The deductibility of interest paid on

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home mortgages is sometimes a target for elimination—but it’s not realistically on the table. A cut in overall income tax rates or an exemption for interest earnings might be.

■ *Liquidity.* Investors find assets that can be sold easily and quickly—i.e., those classified as relatively liquid—more desirable than assets with little market flexibility. Greater liquidity tends to reduce risk and increase the supply of loanable funds, relaxing pressures on interest rates.

Liquidity goes only one way over time—up. Financial markets routinely develop new ways to make it easier for people to buy and sell assets. Junk bonds are an example. Innovations that increase liquidity tend to put downward pressure on interest rates.

■ *Term to maturity.* The longer the loan—all else equal—the higher the interest rate required to compensate investors for having their money at risk. One-month

Treasury bills and 30-year government bills are both liquid with negligible default risk—but inflation and rate risk are lower for bills than bonds. So the short-term bills pay lower rates than the long-term bonds. In the current environment, the average term to maturity on loans and assets isn’t likely to change much.

LINKS AMONG RATES

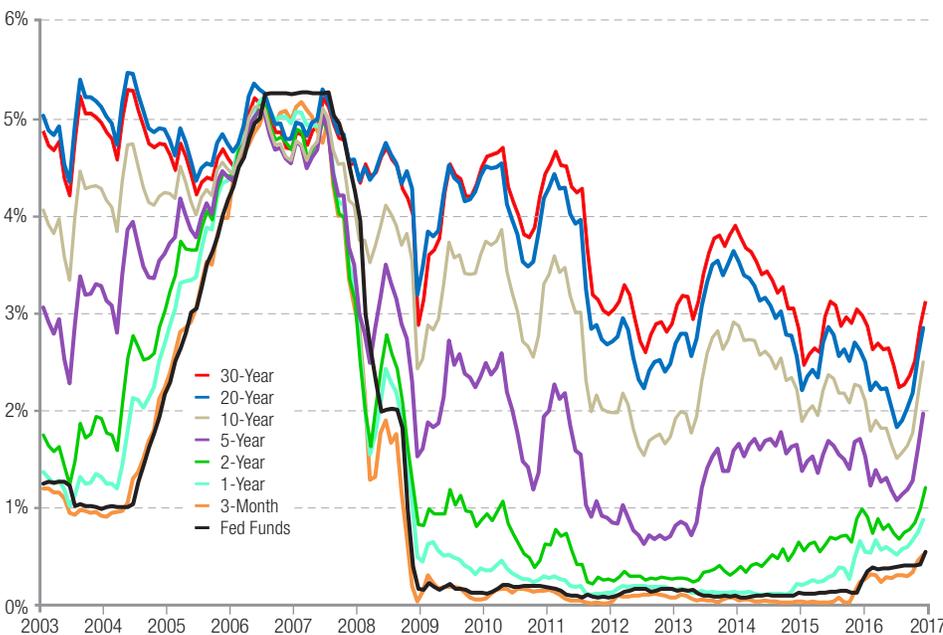
The sprawling, complex American economy allocates credit through a wide array of financial instruments—30-year mortgages, long- and short-term Treasuries, prime commercial paper, savings accounts, junk bonds, payday loans. A complete inventory of U.S. financial instruments may top 100—each with an idiosyncratic interest rate, forged by the factors we’ve just discussed.

While interest rates vary across asset and loan markets, market forces connect many of them. The prime rate for top corporate borrowers, for example, is typically tied directly to the fed funds rate, rising in lock step with it. Rates on other instruments, such as CDs, T-bills and short-term Treasuries, follow the fed funds rate—but not as closely (see chart left). Long-term rates are less sensitive than short-term ones to changes in fed funds rates.

It’s relatively easy to move money among assets to seek higher return or refinance loans to find lower rates. This kind of scrutiny and arbitrage connects many interest rates, the churn of transactions bringing the various rates more in line with each other.

While interest rates are to some degree linked, what we see in practice is tight connections between some rates but loose ones among others. It’s even possible for rates to move in opposite directions. The key to the correlation is the ease of substituting one type of investment for the other.

Fed Funds Key to Short-Term Rates, Not Long-Term Ones



Some loans aren't good substitutes for others, so borrowers facing high rates in one market can't easily shift to another market. When interest rates are low on mortgage loans relative to corporate bonds, for example, companies can't tap the mortgage market to finance investment. These two rates aren't tightly linked. For entrepreneurs, however, cash-out mortgage refinancing can be an alternative to borrowing from a bank, so rates on mortgage loans and personal loans are more tightly linked.

What's likely to happen to interest rates over the next year, or even the longer term of, say, three or four years? Answering the question requires more than tracking the Fed's actions and pronouncements. We need to look at the variety of factors that will be pushing and pulling the various

interest rates in different directions.

Some short-term rates are likely to rise with the federal funds rate—in particular, the prime rate and rates on CDs and short-term Treasury securities. Other rates will rise to a lesser extent—such as rates on medium-term Treasury securities and corporate debt. Some rates won't rise at all, and some may even fall.

The prospect of continued tame

inflation and subpar economic growth will be particularly important. They influence loan demand and several types of risk—among other things. The low inflation/middling growth scenario argues against big rate hikes in the foreseeable future. Barring major surprises on inflation or growth, interest rates will rise in coming years, but they're likely to stay well below what we saw between 1975 and 2000.



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CHARTING THE ECONOMY

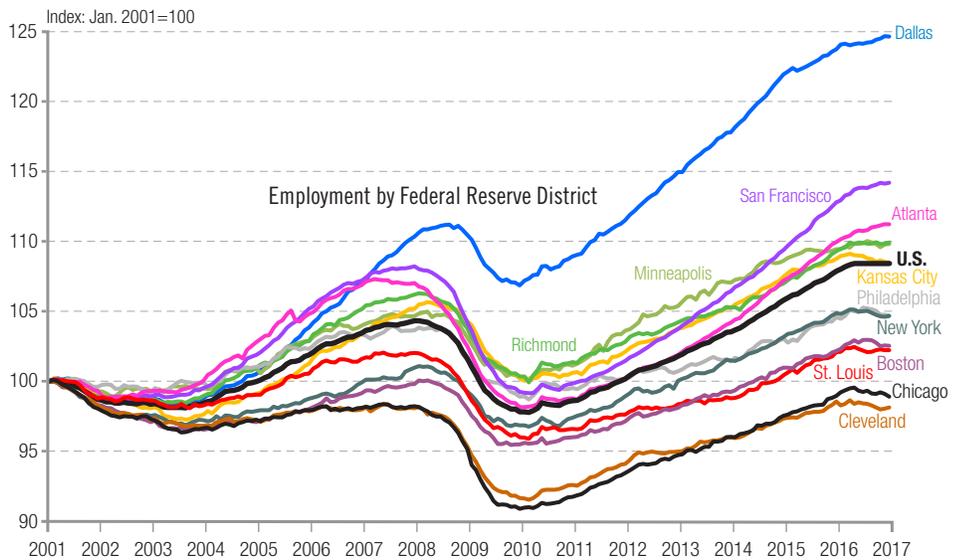
Fed Job-Growth Gap: Dallas on Top but Chicago, Cleveland Lag

The U.S. economy added nearly 13 million jobs since 2001, but the gains have been spread unevenly across the country. Total employment in each of the 12 Federal Reserve districts can be used to show the geography of American jobs.

The Dallas Fed's region, which includes Texas and parts of northern Louisiana and southern New Mexico, posted a 25 percent increase in jobs since 2001—the best by far (see chart, blue line). The San Francisco Fed's region came in next at about 14 percent, followed by Atlanta.

The Minneapolis and Richmond regions are a bit above the national average (black line), and Kansas City matches it. The Philadelphia, New York, Boston and St. Louis regions fared worse than the nation as a whole—but they at least added jobs.

Not so for the Chicago and Cleveland regions in the nation's struggling industrial heartland. Their employment remains below 2001 levels, although both regions have been adding jobs since 2010.



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