EDUCATION

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The 5000-year view of rates & the economic consequences 15/11/21

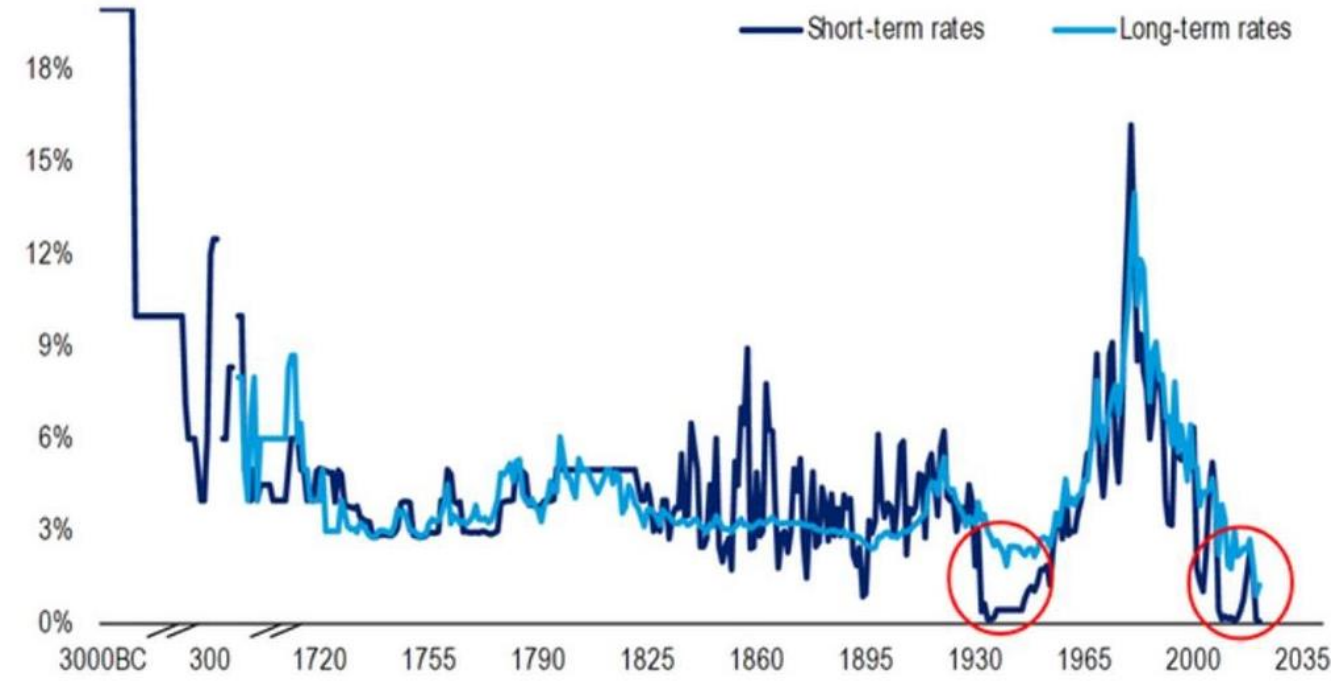
Author – Lance Roberts (source)

Bank of America wants you to know that 'Interest rates haven't been this low in 5,000-years. 'That's right, 5000 years. 'In the next 5,000 years, rates will rise, but no fear on Wall Street this happens anytime soon,' said David Jones, director of global investment strategy at Bank of America. This should not come as a shock to anyone who has been watching, given that the Federal Reserve (FED) balance sheet is now an astonishing $8.5 trillion, and that fiscal spending has caused the U.S. debt to balloon to over $28 trillion (For reference, the U.S. GDP is $22 trillion).

All of this really means that the FED and the U.S. are in a tough spot. They need a lot of growth to dig out from mountains of debt, but they cannot afford for rates to move too high or debt service will become an issue.

Chart 2: Price of money remains at 5000 year lows

Interest rates since 3000BC



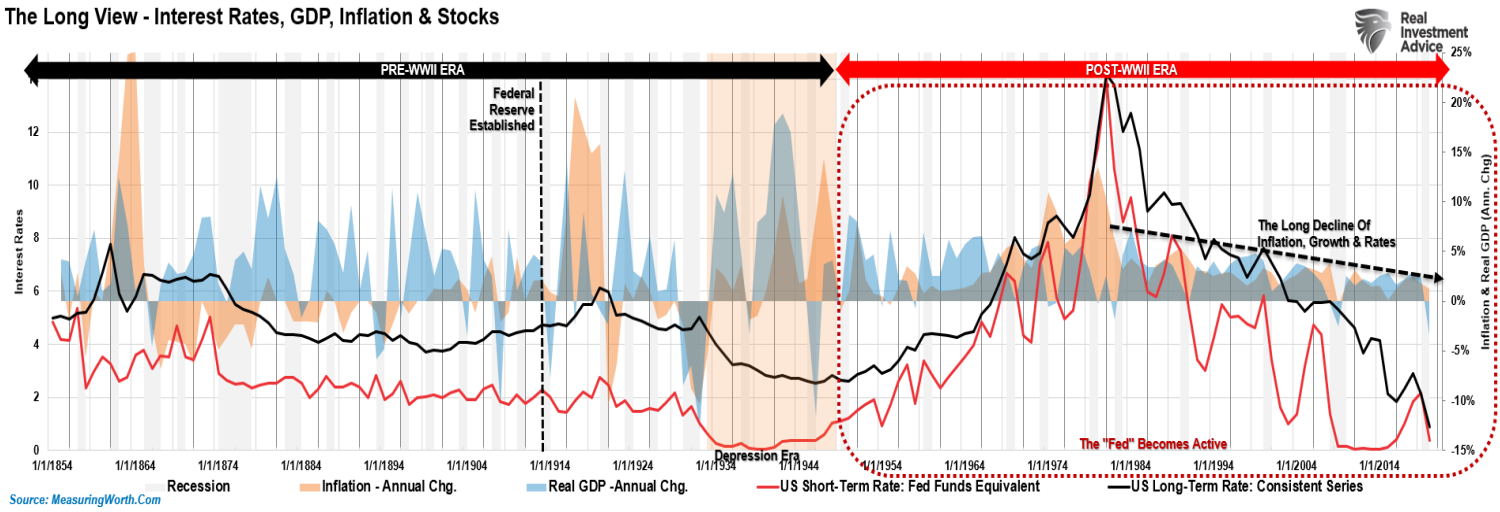
Source: BofA Global Investment Strategy, Bank of England, Global Financial Data, Homer and Sylla "A History of Interest Rates" (2005)

Short-term rate rise can't last

Five factors are spooking the bond market.

1. Debt ceiling battle: short term, low impact
2. Supply chain disruptions: medium term, medium impact
3. Trade deficit: long term, low-to-medium impact
4. Biden's build back better spending plans: long term, high impact
5. Wage spiral: long term, high impact

A long history of rates & economic growth



Interest rates are a function of the general trend of economic growth and inflation. More robust rates of growth and inflation allow for higher borrowing costs to be charged within the economy.

Unlike stocks, bonds have a finite value. At maturity, the principal gets returned to the lender along with the final interest payment. Therefore, bond buyers are very aware of the price they pay today for the return they will get tomorrow. As opposed to an equity buyer taking on investment risk, a bond buyer is loaning money to another entity for a specific period. Therefore, the interest rate takes into account several substantial risks.

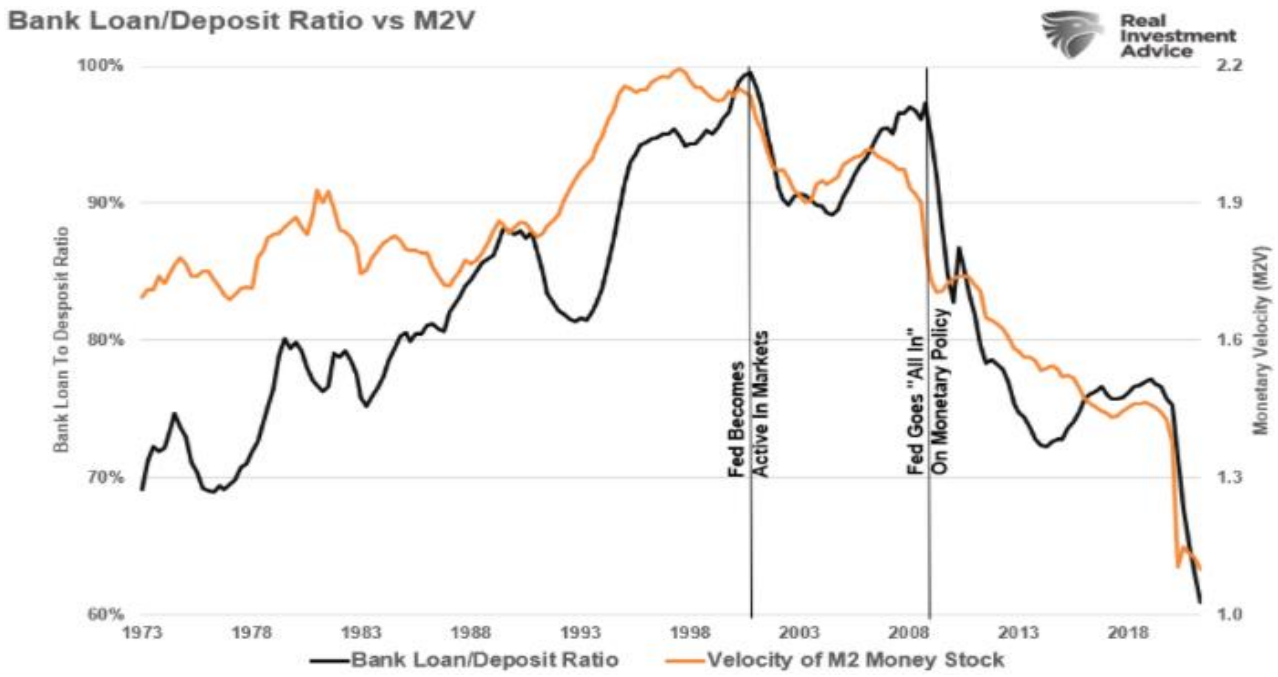
1) Default risk *2) Rate risk* *3) Inflation risk* *4) Opportunity risk* *5) Economic growth risk*

What caused rates to rise previously

Interest rates rose during three previous periods in history. During the economic/inflationary spike in the early 1860s and again during the *"Golden Age"* from 1900-1929. The most recent period was during the prolonged manufacturing cycle in the 1950s and 60s. That cycle followed the end of WWII where the U.S. was the global manufacturing epicentre.

However, notice that while interest rates fell during the depression era, economic growth and inflationary pressures remained robust. Such was due to the very lopsided nature of the economy at that time. Much like the current economic cycle, the wealthy prospered while the middle class suffered. Therefore, money did not flow through the system leading to a decline in monetary velocity.

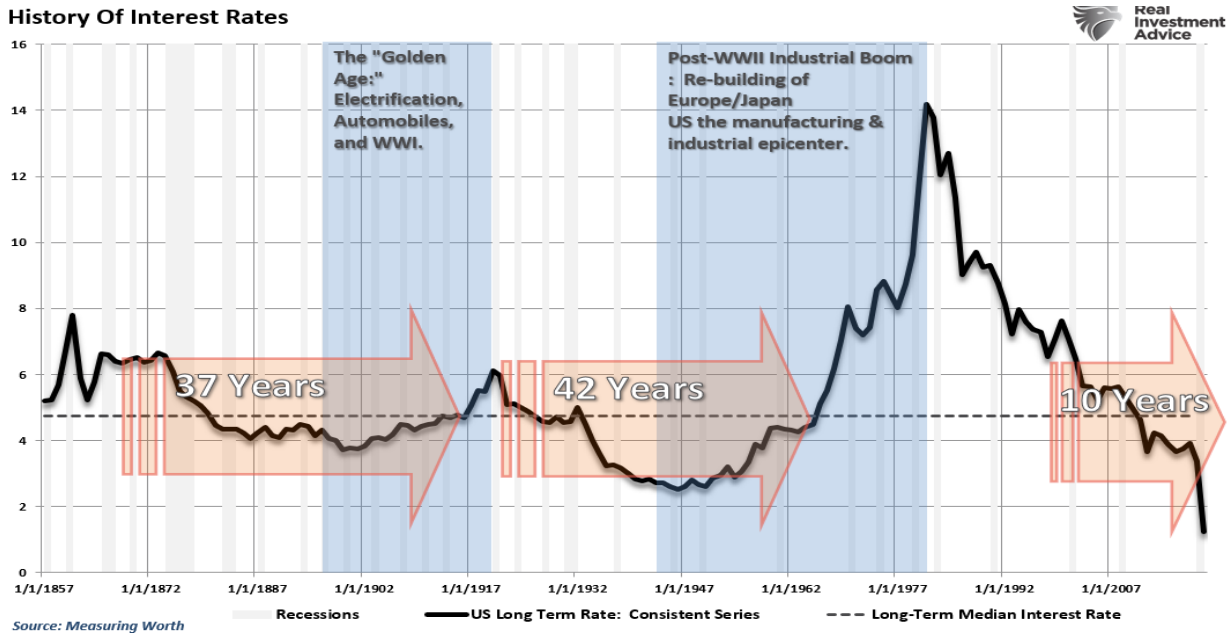
Currently, the economy once again is bifurcated. The upper 10% of the economy is doing well, while the lower 90% remain affected by high joblessness, stagnant wage growth, and low demand for credit. Moreover, for only the second time in history, short-term rates are at zero, and monetary velocity is non-existent.



The difference is that during the *"Great Depression,"* economic growth and inflationary pressures were at some of the highest levels in history. **Today, the economy struggles at a 2% growth rate with inflationary pressures detracting from consumptive spending.**

Low rates can last a long time

Interest rates are ultimately a reflection of economic growth, inflation, and monetary velocity. **Therefore, given the globe is awash in deflation, caused by weak economic output and exceedingly low levels of monetary velocity, there is no pressure to push rates sustainably higher.** The dashed black line is the median interest rate during the entire period (below).



(Note: Notice that a period of sustained low interest rates below the long-term median averaged roughly 40 years during both previous periods. We are only currently 10-years into the current secular period of sub-median interest rates.)

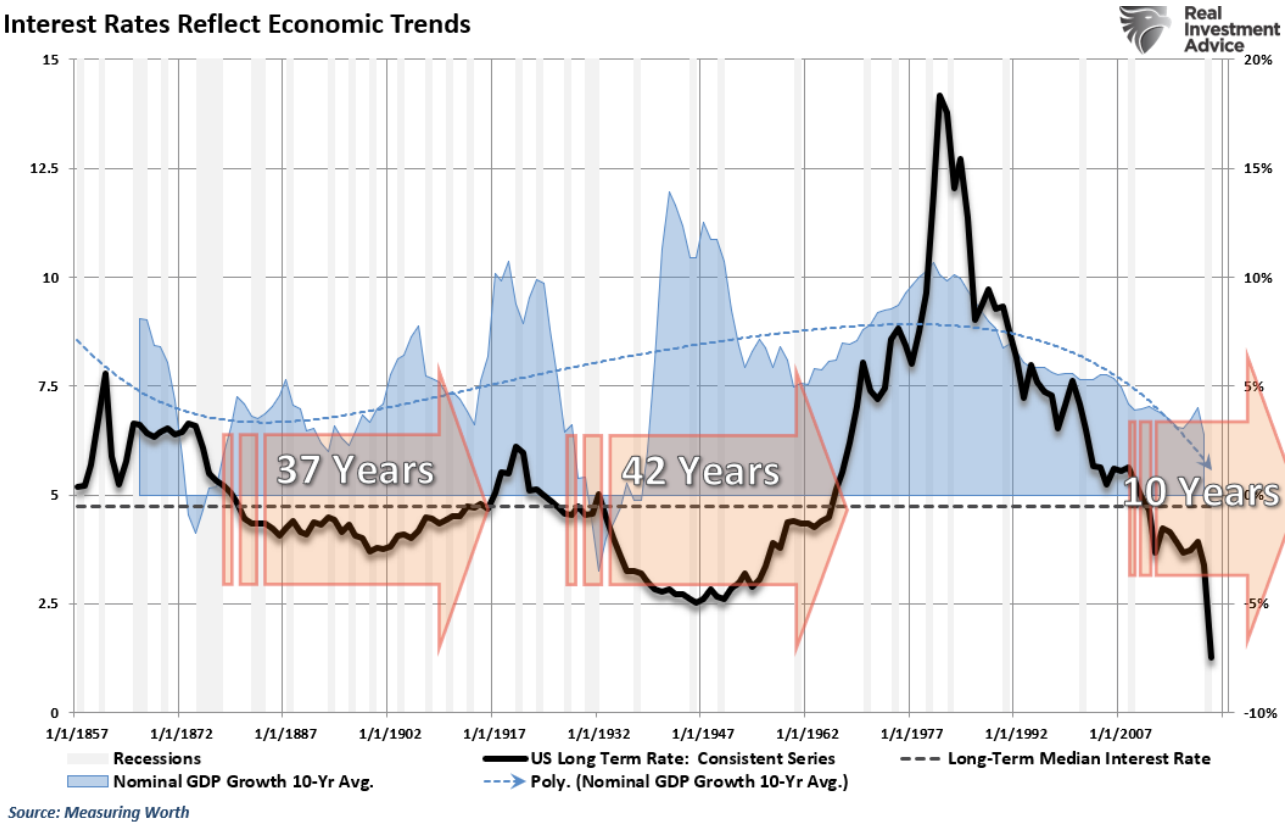
The following chart overlays the 10-year average economic growth rate. As you will notice, and as discussed above, **rates rise in conjunction with more substantial levels of economic growth. Such is because more substantial growth leads to higher wages and inflation causing rates to rise accordingly.**

There are some interesting differences between the *"Great Depression"* and the *"Great Recession."* **During the depression, the economy grew at 13% and 18% on an annualised basis. Today, the current economic cycle of 2.5% and 2.7%.** What plagued the economic system during the depression was the actual loss of wealth following the "Crash of 1929" as a rash of banks went bankrupt, leaving depositors penniless, unemployment soaring, and consumption drained. While the government tried to assist, it was too little, too late. **The real depression, however, was not a statistical economic event but rather an absolute disaster for** *"Main Street"* (average American investor).

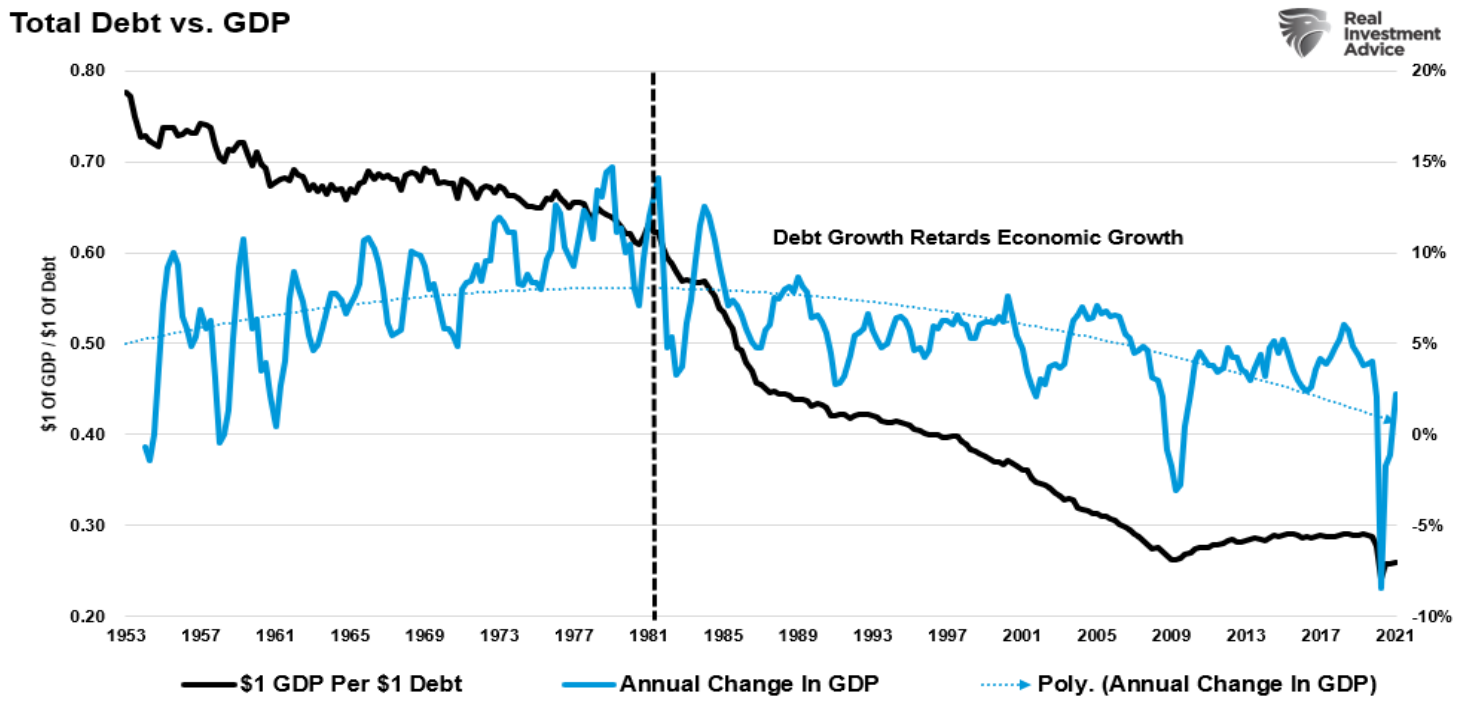
During the current period, real economic growth remains lacklustre. In addition, real unemployment remains high, with millions of individuals simply no longer counted or resorting to part-time work to make ends meet. Finally, with more than 100-million Americans on some form of government assistance, the pressure on *"Main Street"* remains.

One crucial difference is the rate of population growth which, as opposed to the depression era, has been on a steady and consistent decline since the 1950s. This decline in population growth and fertility rates will potentially lead to further economic complications as the *"baby boomer"* generation migrates into retirement and becomes a net drag on financial infrastructure.

Today, despite trillions of dollars of interventions, zero interest rates, and numerous bailouts, the economy has yet to gain any real traction.

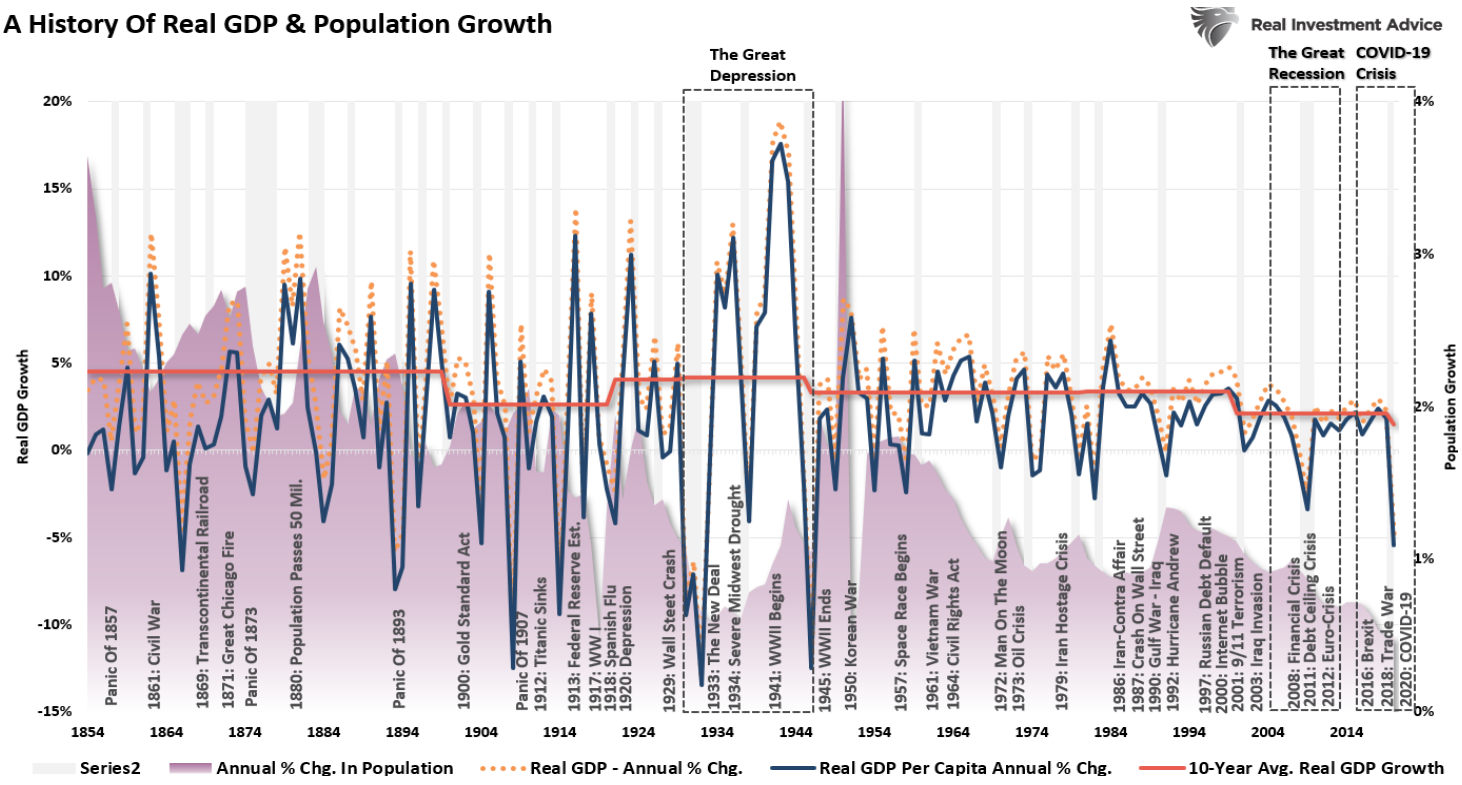


Today, the U.S. is no longer the manufacturing epicentre of the world. Labour and capital flow to the lowest cost providers to effectively export inflation from the U.S., and deflation gets imported. Technology and productivity gains ultimately suppress labour and wage growth rates over time. The chart below shows this dynamic change which began in 1980. A surge in debt was the offset between lower economic growth rates and incomes to maintain the "American lifestyle."



A demographic challenge

The chart below shows both the long-view of real, inflation-adjusted, annual GDP growth and on a per-capita basis. Also included the annual growth rates of the U.S. population (source: MeasuringWorth.com).



The end of the bond bubble

The problem with most forecasts for the end of the bond bubble is the assumption that we are only talking about the isolated case of a shifting of asset classes between stocks and bonds.

However, the issue of rising borrowing costs spreads through the entire financial ecosystem like a virus. The rise and fall of stock prices have very little to do with the average American's participation in the domestic economy. Interest rates, however, are an entirely different matter.

While there is not much downside left for interest rates to fall in the current environment, there is not a tremendous amount of room for increases. Moreover, since interest rates affect *"payments,"* increases in rates quickly negatively impact consumption, housing, and investment.

Will the *"bond bull"* market eventually come to an end? Yes, eventually. However, the catalysts needed to create the economic growth required to drive interest rates substantially higher, as we saw previous to 1980, are not available today. Such will likely be the case for decades to come. The Federal Reserve has yet to conclude we are caught in a *"liquidity trap"* along with the bulk of developed countries.

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