first allied
Gregory E. Cater CWS®
Certified Wealth Strategist
Registered Principal
6411 Ranch Park Drive
Magnolia, Texas 77354
www.firstallied.com
936-321-1542
877-433-9218 Toll Free
936-271-0801 Fax
gcater@1stallied.com

Rates are going up, right?

First you have to identify what rates we are talking about. Short term, intermediate, long term... CD, mortgage, muni, or corporates? The yield curve is not static. You can have inverted, humped, and what we are most familiar with – the upward sloping curve. Rates can move on one part of the curve and not the other.

Let's assume you are talking about the 10-year treasury, or any other fixed, similar duration, investments – assuming no credit risk.

What makes it go up or down? Supply and demand – selling and buying, more of one vs. the other.

So what is going to cause people to sell their treasuries and cause the rates to go higher?
With no credit risk – it must be: FEAR of future - higher interest rates.

So putting aside fear, what really leads to higher rates? Outside of shocks, *wage push inflation* or *demand pull inflation* are the most common.

Wage Push:

Wage and cost push inflation is a cycle of employees demanding and getting higher wages. Employers then have to raise the price of their goods thus offsetting the cost of the higher wages, leading to a demand for even higher wages, etc. This can be set off by other higher input costs, but "wages" is key.

The largest input cost for employers is employee cost. And that is even truer in a service driven economy. So before an employer gives into the demand of higher wages – assuming there is demand for his service – they are going to try different things, including outsourcing to cheaper labor markets and buying/investing in cost-saving technologies.

Why don't employers like giving out higher wages? Because of the rigidity of wages – especially when wages are the highest component of cost of goods sold. It's hard or almost impossible to lower wages, people would rather be fired. Many will quit before taking a pay cut, and all will immediately look for other employment when the talks of cutbacks begin.

Are we seeing higher wages?
No.

If employers don't pay current workers more they can spur economic activity another way - by hiring more employees and increasing their output, adding a 3rd shift, building new factories, etc.

Are we seeing increased capacity utilization or hiring figures that suggest a rapidly growing economy?
No and no.

Securities offered through First Allied Securities, Inc., Member FINRA/SIPC.
Advisory services offered through First Allied Advisory Services, Inc.

Demand Pull:

Before you can understand how demanders of money can cause inflation, it's important to understand how sellers of bonds don't move rates – only "demanders" of money move them.

This is the primary difference between the secondary market and issuance market. In the secondary market supply and demand/ buyers and sellers control prices and yields. If there are more sellers than buyers, prices are going to go down, and yields up. But did rates really go up?

We can look back at the European Union (EU) debt crisis and see the yields of some of the EU members debt trading with yields of 7%- 9%, and Greece at one time trading at 20+%. Was this their cost of capital? Did Greece have to pay 20% for a 10 year paper? Of course not. Sellers changed the price of the bond reflecting an increase in current yield, but the cost of capital to the issuers was not changed. Issuers will always try to enter the market at a rate that is reasonable and sustainable.

Another example found in the municipal market following the debt crisis and subsequent housing bubble is when California went from $20 billion in General Obligation (GO) bond issuance in 2009, to $10 billion in 2010, to less than $5 billion in 2011. Issuers will always try to enter the market at a rate that is reasonable and sustainable.

Rates can move up if people and businesses demand more money. They need to be able to – or at least think they can – deploy the capital and earn an acceptable return. When this new money is spent on a limited number of goods prices rise.

Let's discuss another important factor while discussing rates – rates as a function in regards to cost of capital.

We know that as the cost of capital goes up and down it changes the volume of economic activity. Projects that are profitable at 2% might not be at 4%. 2% to 4% might not sound like much, but that is a 100% increase in the cost of capital. So, a decrease in cost of capital leads to an increase in economic activity (and vice versa). This is one of the main tools of the Fed. They increase and decrease the rate – the overnight rate – trying to control economic activity. In the past we have seen the Fed use their ability to control (on the short end) and influence rates to slow the economy down during high inflation periods (Volker) and also during recessions to prop up the economy and soften the blow (Greenspan and Bernanke). This is basic monetary policy 101.

What is our current monetary policy stance?
Extremely and unprecedentedly accommodative.

Are they meeting their stated objectives of 2% inflation and full employment?
No and No.

Not only can they not get to full employment and 2% inflation, the GDP has been averaging 2% growth. The Fed has not been able to reach their targets or spur economic growth in an unprecedented accommodative stance – why would they even think of tightening and increasing the cost of capital for individuals and businesses?

So if the Fed is not in a position to tighten and raise rates, and many believe they have little control over anything more than the overnight rates and a megaphone to influence the longer end of the curve...

What else can move rates?

Do we have individuals and businesses wrapped around the corner trying to get loans? No.
Are individuals and businesses looking to add to their debt load because the future growth prospects far outweigh higher funding cost?

No, no one is "demanding" money. Money is cheap and there is no demand, so rates are not going higher. Banks are sitting on a lot of money earning .25%. If there was any ability by the banks to earn more, they would.

Is it because the economy is picking up from crisis levels, prospects for growth and jobs are increasing? Business and individuals can afford a little higher rate?

Generally strong economies have modest rates because the fear of default is low. Remember Greece's secondary market at 20%? That is what economies in fear of default pay, not strong, growing, robust economies.

What about the bond vigilantes? Are they going wake up and put an end to this fiscal and monetary nonsense in Washington and drive yields higher?

The Japanese Government Bond (JGB) 10 year is at .74% and the German bund is at 1.9% and the US is at 2.8%? And it's going higher? To say we are the cleanest dirty shirt is an understatement. Japan has been in and out of deflation and near zero growth for over a decade and Germany and the EU are barely squeaking out positive GDP growth almost 5 years after the crisis. We are the world currency, and since the crisis and all the monetary and fiscal largess our dollar is stronger, and we have the deepest and safest debt market in the world. 1.5% on treasuries might have been a flight to safety out of the EU, but 2.8% (where rates where just 2 years ago) is not a panic and not something to fear. 2.8% two years ago – didn't that mean 3-3.5% was right around the corner? Actually, the opposite happened and we moved lower. Why do you think it will be different this time?

Rates will move higher when QE ends.

Which rates and which part of QE will end? Looking back at the last QEs we see that rates went LOWER at the end of the program and rose during the QE program. We are in the middle or near the end of QE3+ and rates have risen. Are they going to rise more when it ends? History does not prove that out.

It's my opinion that rates have moved off of FEAR. Every advisor, financial journalist and TV producer cannot get out of their way in predicting higher rates. Almost all new financial products are positioned with low duration or floating rates for the eventual boom in rates. Even FINRA has stepped into the fray. Has there ever been a collapse more predicted, written about or feared, that had financial products designed specifically for it? Looking back at the last substantial market moves – dot com, housing, debt crisis – where were the pundits, advisors, financial product divisions then?

FEAR has given us a great opportunity in the fixed income market. Not since Meredith Whitney on 60 Minutes have we had this large of a mispricing in the fixed income arena.