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Special Report

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Interest Rates Made Simple

By James Grant

Where interest rates are going is the financial markets' eternal stumper. Why they went where they have already gone is a question only slightly less difficult to answer. But it is no less relevant to the art of moneymaking. So we ask: In a world of technological miracles and folk-hero central bankers, why are yields not falling?

Before turning to the wonderful work of James A. Bianco, eponymous chief of Bianco Research, Barrington, Ill, we have a couple of causes to propose. First, the eight-story, $37 million sign just erected in Times Square by Nasdaq ("Nasdaq Adds the Biggest, Brightest Light to the Times Sq. Glare," said the headline in the December 29 *New York Times*). Second, the blowout, six-figure millennial party (featuring an Amersterdam red-light district motif) thrown recently in the staid leafy suburb of Bedford, N.Y and reported in loving detail in the January 2 *New York Times.* Each phenomenon speaks volumes about financial expectations, and in each case the expectations are wildly and uninhibitedly bullish.

"Why the New Paradigm Argument is Irrelevant," is the title of the Bianco analysis, which you may read in its entirety at the click of a mouse: http://www.biancoresearch.com/com10v22.pdf. His conclusion is simplicity itself. Interest rates will rise until it doesn't pay to borrow any more. The best and handiest measure of the expected rate of return on borrowed funds is the expected rate of growth in the GDP. Thus, prosperity is bearish for the bond market, though not for the reasons usually adduced. Prosperity does not cause price inflation. It does, however, raise the tolerance of potential borrowers to higher interest rates. "Economists Are Euphoric About the Prospect for 2000," *The Wall Street Journal* reported Monday, not helping matters.

Theorists of the New Era will object that rates should be falling because inflation has been laid low (thanks in part to the same technology on which Bianco's bearish thesis is effortlessly disseminated to the readers of *Grant's*). In particular, they contend yields should fall until they reach some reasonable level, one grounded, for example, in a 3% "real" rate, a rate they believe is a steady and reliable benchmark of inflation-adjusted return. It is supposedly as certain as the flight path of Qualcomm.

It isn't, as every seasoned practitioner knows (nothing is certain in financial markets except surprise and upset). Real rates have averaged 1.77% since the end of World War II, but 4.93% since the start of the bond bull market in September 1981. Thus, a real rate of 3.96% — the latest estimated reading — is, in fact, below the mean of the past 19 years. What, then, would constitute a high real rate? Let's say, says Bianco, a yield one standard deviation above the postwar average, i.e., 5.58%. Given a current inflation rate of 2.63%, he adds, only a 30-year rate of 8.21% would satisfy that particular definition of "high" (you may have your own).

Not that these facts alone constitute a clinching bearish case for bonds. The point is that real rates are not fixed, but variable. What makes them rise and fall? The growth rate of the economy answers Bianco. "Think of this measure as an asset valuation model with the asset being the entire economy," he proposes. "If the asset, as measured by nominal GDP, returns a rate higher than the prevailing interest rate [he uses the five-year Treasury yield], then it makes sense to borrow and expand. One can make money in such an environment because the asset has a higher return than the cost of borrowing. This will cause an increase in the demand for money, thus putting upward pressure on the price of money, interest rates. This will last as long as yields are below the year-over-year change in nominal GDP (or at least the perception that interest rates are below nominal GDP)."

Financial factors, too, bear on the demand for borrowed funds, and they have never loomed larger than they do today. Prior to 1996, observes Bianco, the capitalization of the stock market was never more than the equivalent of 100% of GDP. Now it's approaching 150%. "Half the American public own stocks," Bianco goes on, "and half doesn't. Half the American public is sort of immune to higher interest rates. Yeah their mortgage rates will go up, but they also own Qualcomm or something else to offset higher interest payments. So they are willing to accept higher rates. The other half pays higher mortgage rates but doesn't own Qualcomm (to use a simple example). Rates have to go high enough to kill the non-equity-owning part of the economy. That will then start to filter into the part of the economy that owns lesser amounts of equity and on into the center. Then pretty soon you look around and say, 'Hey, we have a real slowdown here.' So it has to be a psychological event —7% or 7 1/2%. That will bring a collective gulp."

If you or the millionaire next door can make 7% a month in equities, why bother with 7% a year in bonds? A rising consumer price index is bearish for fixed-income securities, all right. But no less so is a soaring Nasdaq. Who knows? Maybe the Nasdaq will be flying lower this year (you can check its progress minute-by-minute on that very generously sized screen in Times Square). A creditor can hope.