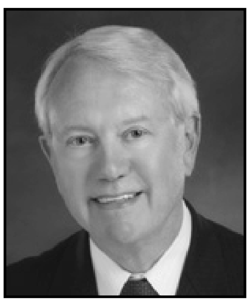
Inside Business
The Hampton Roads Business Journal | Insidebiz.com
JANUARY 7, 2019 $1.00

Here's what will affect interest rates in 2019

By Jim Flinchum

One of the lingering effects of the Great Recession in 2008-2009 is that we still don't have normal interest rates. Pushed too low and held there for too long, forecasting interest rates has never been more important, nor more difficult.


Jim Flinchum

Nonetheless, I expect long-term interest rates to increase substantially more than short-term rates in 2019.

Short-term interest rates are directly governed by the Federal Reserve. The Fed has been telegraphing the need to raise or normalize short-term rates for years, which it has been doing for the last four years.

The President howled on the last increase, threatening to fire Fed Chairman Jerome Powell. (Of course, I've never met a real estate developer who wanted higher interest rates.) Still, nobody likes to be publicly berated by the president, especially when the president is correct.

The Fed has said it expects to increase short-term rates another one to two times this year. I don't believe that will happen. One reason is that, contrary to popular wisdom, there is no inflation to fight. If anything, the Fed is more likely to reduce the rate as the economy slows to a more normal rate.

Remembering that corporate profits are the mother's milk for stock prices, the stock market is adjusting from 20 percent increases in corporate profits in 2018 to still healthy 7 percent to 8 percent increases. The stock market will adjust to this and does not indicate any recession for 2019.

When short-term rates become higher than long-term rates, it is called an inverted yield curve and has long been a predictor of recessions. While we are close to that point now, I don't believe it will be true this time. But, the more existence of an inverted yield curve spooks both the stock market and the President. I think this effectively puts a ceiling on short-term rates for now.

Unfortunately, Powell has a blind spot to long-term interest rates, and that's a growing problem. Long-term rates are facing four big problems.

First, the supply of bonds is expected to increase close to a trillion dollars in 2019, as the government finances the massive budget deficit by selling bonds. That means the trillion borrowed by the government will not be available to the rest of the economy, putting upward pressure on the interest rates. This is called crowding-out.

Second, to support the economy as it recovered from the recession, the Fed entered into quantitative easing, which means it was buying government and mortgage bonds on the open market. When they bought a bond, they paid cash. This pushed liquidity into the economy. Eventually, the Fed owned about $4.5 trillion of such bonds.

When the Fed stopped buying bonds, overall market liquidity started to dry up. Decreasing liquidity makes it more valuable to those borrowers who need it and puts upward pressure on interest rates, especially longer-term rates.

Third, the Fed has started reducing its bond portfolio in what is called quantitative tightening. As the Fed sells bonds into the market, it is taking cash out or withdrawing liquidity from the market. This puts even more upward pressure on interest rates. In October, the Fed doubled the rate of bond sales to $50 billion monthly, which is a lot of liquidity to lose each month. This was a mistake.

...continued

Fourth, the European Central Bank and the Bank of Japan have recently stopped their quantitative easing programs. That means they are no longer injecting liquidity into their markets either. While they have not started to sell bonds yet, it is obvious liquidity is already decreasing globally. This will put further upward pressure on interest rates.

Jeff Gundlach of DoubleLine Capital is known as the bond king. He expects interest rates on 10-year treasury bonds, for example, to increase from about 2.75 percent now to about 6 percent by 2021. While I agree long-term rates will rise, I don't see them rising that much nor that soon. Regardless, this will have major consequences, especially for investors in long-term bond funds and even holders of individual bonds.

As interest rates rise, the market value of fixed-income investments fall – some more than others. The longer the term to maturity, the greater the loss in market value. This suggests short-term bonds are preferable to long-term ones.

At least owners of individual bonds can hold their bonds to maturity and get their original investment returned. That is not true for investors in bond funds, especially long-term bond funds.

Is the current market slump due to the Fed's actions? No, but it is a major contributor. The combination of a higher stated rate plus the withdrawal of liquidity from selling bonds produces an effective shadow rate that is much higher and should be reduced. Some estimate it is twice the stated rate. The Fed must either pause the rate increases or pause the bonds sales or both.

Currencies tend to appreciate when interest rates are rising. For now, the dollar is strong, reflecting our interest rate increases over the last few years. I don't see that changing for the first half of the year.

The Great Recession started as a financial crisis. (Remember subprime bonds?) Reducing liquidity makes a financial crisis much more likely. Already, spreads on high yield bonds are increasing and the leveraged loan market is falling. These are danger signs to be watched.

Lastly, our national debt is rapidly approaching $22 trillion. If average interest rates increase a mere quarter point overall, then our debt service increases $55 billion every year. It makes Trump's wall look insignificant as a one-time expenditure of $5 billion.

Jim Flinchum *is a NAPFA-registered financial advisor in Virginia Beach and a member of the National Association of Business Economics. He is also the author of the award-winning fiction book "Paybacks" and can be contacted at baycapitaladvice.com*