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US Economic and Investment Perspectives

Low Real Rates Should Continue to Fuel Real Asset Prices

The persistently low level of real interest rates has sparked lively debates over two essential questions: Why are rates remaining so low, and what are the investment and economic implications of this?

Determinants of Real Rates

Real rates are influenced primarily by fundamentals and inflation expectations, the most obvious fundamental factor being supply and demand. For example, real rates are generally low when investment (demand for capital) is sluggish or when savings (the supply of capital) increases. In this context, it has been argued that today's low real rates reflect the rise in savings by emerging economies, the global increase in corporate savings, and the lingering hesitancy of businesses worldwide to make investment commitments.

In our view, inflation expectations probably account for at least as much of the variability in real rates as does supply and demand. Unfortunately, it is not always easy to discern how inflation expectations are formed, as these can be at odds with basic economic trends for extended periods. For example, real short-term interest rates remained negative for almost the entire economic expansion in the late 1970s. Inflation expectations never caught up with actual inflation because investors never believed accelerated inflation would persist, as it indeed did.

In the 1980s, the reverse was true. Real interest rates rose to levels never before seen in the postwar period and remained relatively high throughout the expansion. This is because high inflation expectations had become deeply rooted following the 1970s experience—influencing both lending and borrowing practices. In reality, however, actual inflation remained well below inflation expectations throughout the cycle.

We believe that today's relatively low real rates stem largely from well-contained inflation expectations. Relatively low long-term inflation expectations are evident in the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia. They are also evident in the median inflation expectations of households responding to the University of Michigan survey. Moreover, the yield spread between 10-year nominal securities and 10-year inflation-protected securities continues to hover around 2.5%—an indication that the market also expects inflation to remain low for some time. The implied long-term inflation forecast of the market is equal to the average inflation rate of the past 10 years.

Interestingly, there may be an important difference between how inflation expectations were formed years ago and how they are formed today. For example, in the past, house prices were a component of official inflation measures and, as such, helped guide inflation expectations. Today, house-price inflation, which is running roughly four times faster than general inflation, is not included in the Consumer Price Index (CPI). Has the removal of house prices from official measures affected inflation expectations? We think it has, but their removal does not mean that consumer behavior will differ from past cycles. Indeed, evidence seems to suggest that investment decisions are guided by actual prices, not reported prices. And even though rising house prices may not be lifting inflation expectations, they are influencing the portfolio and investment decisions of households. As such, house prices should not be excluded from the general inflation picture of the financial markets because they reflect important shifts in demand and capital.

The theoretical argument for including asset prices in inflation measures was established long ago. In the February 1973 issue of the *Journal of Money, Credit and Banking*, Armen Alchian and Benjamin Klein, professors at the University of California, argued in an article entitled "On a Correct Measure of Inflation" that "monetary pulses are transmitted to the real economy" by changes in asset prices, among other things. Excluding them from official price statistics, the professors wrote, would result in

serious measurement errors that could lead to mistaken monetary policy. Interestingly, in 1973, when house prices were still part of the official CPI, they argued that other asset prices such as stock prices should also be part of a broad price measure.

With this in mind, we wanted to know how the pattern of real interest rates would look if nominal interest rates were deflated by a measure that includes asset prices. So we adjusted the nominal federal funds rate and nominal 10-year Treasury yields by the year-over-year change in our proprietary broad price index. This index includes prices of currently produced goods and services as measured by the consumer and producer indices, along with house prices and stock prices. The weighting scheme places much more weight (80%) on the prices of currently-produced goods and services and much less weight (20%) on asset prices.

As illustrated in **Display 1**, the results show that for almost three consecutive years, real short-term rates (as adjusted by our broad price index) have actually been negative, remaining at or below levels not seen since the late 1970s. Real long-term rates have also remained negative, another rare phenomenon. While this in itself is not new, the depth and dimension of the negative real-rate structure is quite surprising. Our analysis shows that real short-term rates were more negative today than they were in the late 1970s and that negative real rates extend all the way out to the 10-year Treasuries even today.

Effects of Low Real Rates

History shows that the economy spends more time at the extreme points of real rate cycles than at their average, though it is not entirely clear why. Or, perhaps it is because inflation cycles are never fully understood or accurately predicted. Perhaps, too, people tend to rely on previous inflation levels to gauge the future—meaning previous low-inflation periods can shape expectations for low inflation in the next cycle (and high levels influence expectations for high inflation.). This, in turn, makes real-rate cycles last longer—irrespective of underlying inflation dynamics.

Typically real-rate cycles do not discernibly influence the macroeconomic picture. For instance, during the 1970s—another period of low real interest rates—the average annual real GDP growth of 4.6% was marginally above the 4.3% annual average of the relatively high-rate cycle of the 1980s.

But real-rate cycles do have very powerful distribution effects in the economy, which have a great influence on asset returns (**Display 2**). Periods of low real rates (such as the late 1970s and today) tend to favor homebuilding, old economy industries and returns on real assets, whereas periods of high real rates (such as the 1980s and the 1990s) tend to favor financial assets and non-price-sensitive sectors.

We think today's relatively low real-rate environment is such that the housing cycle, the commodity price cycle and the powerful returns to real assets will run far longer and be far greater than anyone expects. This view runs counter to conventional thinking because many think housing prices are too high and that commodity prices are unsustainable.

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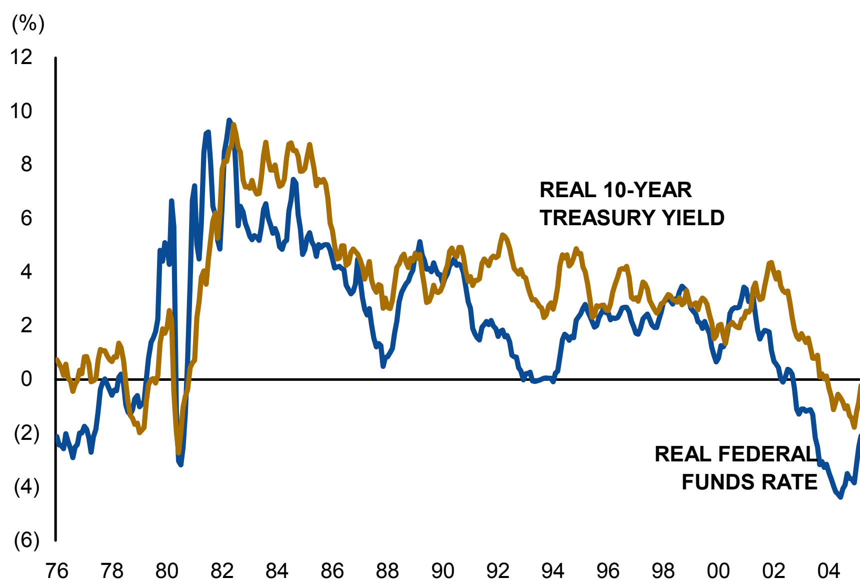
Display 1: Real Rates Remain Very Low

Real Interest Rates: Nominal Yields Adjusted By the Broad Price Index



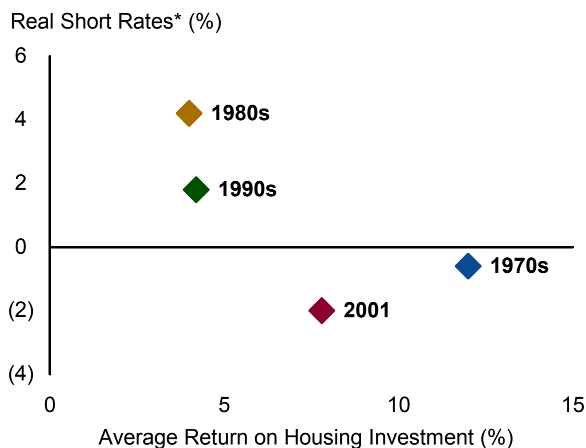
Source: Alliance Capital Fixed Income; July 15, 2005

Real interest rates (as adjusted by our broad price index) have been at or below levels not seen since the late 1970s. Real long-term rates have also remained negative, another rare phenomenon. While this in itself is not new, the depth and dimension of the negative real rate structure is quite surprising. Our analysis shows that real short rates are more negative today than they were in the late 1970s, even for 10-year Treasuries.

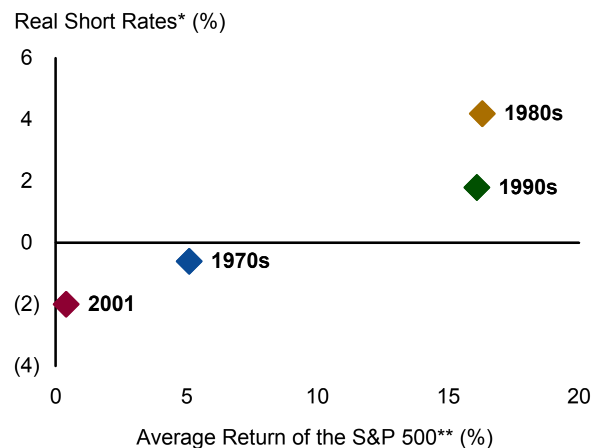
Display 2: Real-Rate Cycles Determine Which Assets Are Winners or Losers

Real Short-Term Interest Rates* versus Average Investment Returns During Economic Expansions

Real Short Rates* vs. House Prices



Real Short Rates* vs. Return on S&P 500**



**Federal funds rate less year-over-year growth of the Broad Price Index;July 15, 2005*

***Excludes dividends*

Source: Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics, Office of Federal Housing Enterprise Oversight and Standard & Poor's

Although real rate cycles typically do not have a discernable macroeconomic influence, they have very powerful distribution effects in the economy as well as a great influence on asset returns. Low real-rate cycles, like the one we are experiencing today, is very bullish for real assets.