



A Tale of Two Interest Rates

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In the fall of 2011, while many investors were feeling uneasy about a possible debt crisis in Greece and its effect on Europe, an odd economic event was occurring to which neither economists nor investors paid much attention. In September of that year, as stocks were stagnating, unable to regain the losses sustained during the 2008 housing crisis, the yield on a 10-year Treasury bond fell to a historic low of 1.98% while the inflation rate (as measured by the Consumer Price Index) was 3.8%. In other words, the rate of inflation was greater than the interest rate on a 10-year Treasury, meaning those who bought the bonds could see the interest they earned eroded by inflation.

Interest rates can be reported two ways, as a nominal rate or a real rate. The nominal rate (or yield) refers to the income received by an investor relative to the asset's principal (face) value. The real interest rate refers to the nominal rate less the rate of inflation. The formula is: $\text{Nominal Interest Rate} - \text{Inflation Rate} = \text{Real Interest Rate}$. As inflation eats into future earnings, it is important to take into consideration how much inflation could diminish future returns. In 2011, when the 10-year Treasury yield was at a nominal rate of 1.98% and inflation was 3.8%, the real rate of return was -1.82%.

While the subject of negative real interest rates may never be a plot for a Netflix mini-series, it is a topic that is relevant for today's investors—much like in 2011, real interest rates turned negative during the COVID-19 pandemic. As of August 2021, the yield on the 10-year Treasury was 1.28% while the Consumer Price Index was at 5.2%, resulting in a real interest rate of -3.92%!

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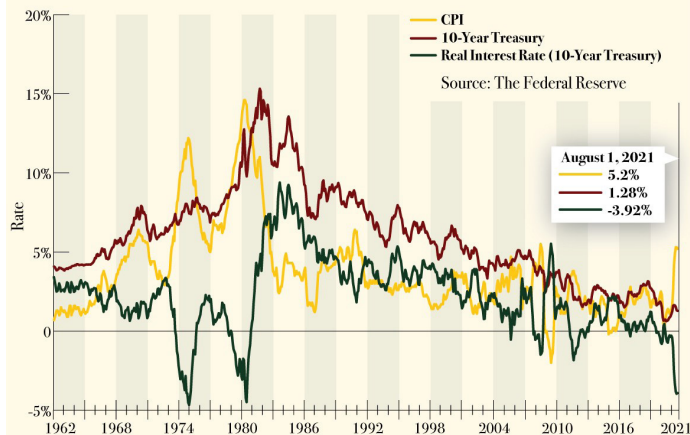
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10-Year Treasury Yield, Inflation Rate (CPI) and Real Interest Rate of the 10-Year Treasury



Investors would be wise to understand real interest rates, as borrowers (especially those who issue bonds) can take advantage of negative real interest rates at the expense of those who buy the bonds. For example, last month Hyatt Hotels Corp. announced that it will soon issue \$700 million in bonds with a fixed rate of 1.3%. With inflation expected to be above 2% for the foreseeable future, those who buy Hyatt's bonds should expect a negative real rate of return. Negative real interest rates are enabling borrowers to expand operations and later pay back their lenders (those who bought the bonds) with depreciated dollars. As this example clearly shows, when the real rate of interest is negative, borrowers win and lenders lose.

To further illustrate this concept, imagine you were to borrow \$100 for a year at 2%, while inflation is at 4%. There would be a real rate of return of -2%. The person who lent the \$100 to you could have used that money to buy \$100 worth of products, but decided instead to lend you the money. In a year, you will pay back the \$100 you borrowed, plus \$2 of interest. However, when the person who lent to you goes to spend their \$102, they will quickly discover that they can no longer buy the same amount of products as before, since inflation has made them more expensive. In theory, it would cost \$104 to buy what had cost \$100 a year before.

While some types of investments are currently providing a negative real rate of return, many stocks with growing dividends not only provide a higher yield than many bonds, but can also negate the effects of inflation. From 2003 to 2020, dividends from the companies that we chose for our clients grew 263%, while inflation had a compounded rate of 43%. Not only did the growth in dividends of these stocks offset the negative effects of inflation, but they provided a positive real return to those who held them.

The reason nominal interest rates are currently so low (and thus why real interest rates are negative) is that during the course of the COVID-19 pandemic, the Federal Reserve purchased over \$3.1 Trillion of federal debt, making it the largest lender to the U.S. government during that period of time. This action by the Fed provided necessary capital to the government to fund many programs; however, as the pandemic declines, the Fed has indicated that it will begin to reduce its purchases of U.S. government debt. When that occurs, interest rates should rise and the real rate of return on bonds should turn positive. Many bond holders will be adversely affected by the rise in interest rates as the value of their bonds will decline, offsetting the low yield that they provide.

Historically, periods of negative real interest rates tend to boost consumption, housing investment and to some degree, business fixed investment, all of which often boost real GDP growth, corporate revenues, and thus earnings. Periods of negative real interest rates have mixed results as far as predicting future stock market returns; however, as we have written in previous reports, dividend growth is a much better indicator of future market performance. Equally as important, growing dividends have provided a positive real return when real interest rates turn negative.

