OPINION

Over the long term, interest rates are going to stay high

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I hate to be the bearer of bad news, but nominal interest rates are not going back below 3 per cent for the foreseeable future. These long-term rates may go down to 3 per cent if there is a recession, but in the long run, they will exceed that by a wide margin.

Nominal interest rates change when real interest rates and expected inflation change. The forces driving real interest rates and inflation (and hence nominal interest rates) can differ dramatically depending on whether we are talking about the short run or the long run.

While in the short run, the real interest rate – adjusted to remove the effects of inflation – is driven by the vicissitudes of the economy and the business cycle, its long-run and secular trend is affected by factors that change only slowly – namely, technology and demographics.

Similarly, in the short run, inflation is driven by the heightened intensity of economic activity and the pressures it entails on productive capacity and the labour and commodities markets. In the long run, it is taxes, economic efficiency and productivity that affect inflationary expectations.

Demographic developments are pushing the real interest-rate trend higher. Baby boomers have been retiring and have stopped saving; in fact, they are in their "decumulation" years, which reduces the supply of funds.

This is happening in the face of increased demand for capital by corporations that need to embed innovation and new technologies into their production processes, as well as by governments that need to borrow to fund structural deficits. To clear the demand-supply imbalance, the real interest-rate trend will be pushed up, not unlike what had happened in the late 1970s.

In the long run, inflationary pressures will also rise.

We may be reaching a peak in productivity growth as experienced baby boomers retire and are replaced by less experienced workers who will nevertheless be in high demand because of low population growth. These workers will demand higher wages. This means higher inflation down the road.

Bank of Canada expected to hold rates steady as economy stalls

Meanwhile, pandemic-related deficits and ballooning debts will require higher taxes going forward.

Other structural changes are also calling for higher inflation in the long run. First, the end of globalization can lead to higher inflation as companies, trying to guard against supply chain interruptions, will be bringing production back to North America – to a higher production cost environment. Second, years of underinvestment in the oil and gas industry, heavy regulation and fear of ESG regulation have shifted not only oil price dynamics but those for all commodities. This implies major shortages in metals down the road at a time when demand will be increasing because of renewable energy and electric-vehicle production.

Indeed, the secular forces behind real interest rates and inflation are slowly revealing themselves. But let's put some numbers on interest-rate possibilities to make this discussion more applied.

Assuming (a) the U.S. Federal Reserve is successful in bringing inflation and expectations down to 2 per cent and (b) the long run real interest rate is 1.5 per cent, as per estimates of Vanguard researchers, this results in a long run (trend) interest rate for, say, 10-year U.S. Treasuries, of 3.5 per cent. In the short run, according to my estimates, the real interest rate can vary between 1 per cent and 2 per cent, depending on the stage in the business cycle the economy is at (this ignores deep recessions or sharp recoveries). Given that the U.S. economy has surprised, moderately, on the upside over the past year, the current real interest rate can be considered to be around 2 per cent. In light of this, 10-year U.S. Treasuries should yield around 4 per cent, which is exactly where they are at.

There is also a risk that the Fed is not able to restrain inflation to 2 per cent and inflation ends up much higher, which is quite likely given my aforementioned discussion.

This would have serious implications for the high-growth stocks that have propelled the market higher in recent years. It may mean a repeat of what happened to the "Nifty Fifty" growth-stock darlings of the 1960s. These stocks had built-in unrealistic growth expectations when rates were lower, but then were punished in the 1970s when rates started to rise. The growth expectations did not materialize, resulting in most of these stocks underperforming the broader market averages.

By the way, rising interest rates may not always be a drag on stock market performance. It all depends on whether long-run earnings growth expectations exceed the rise in interest rates. I see little likelihood, however, of this happening.

The bottom line is that we may be stuck in a period of stagflation – low growth and high inflation/interest rates, which the markets have yet to discount.

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