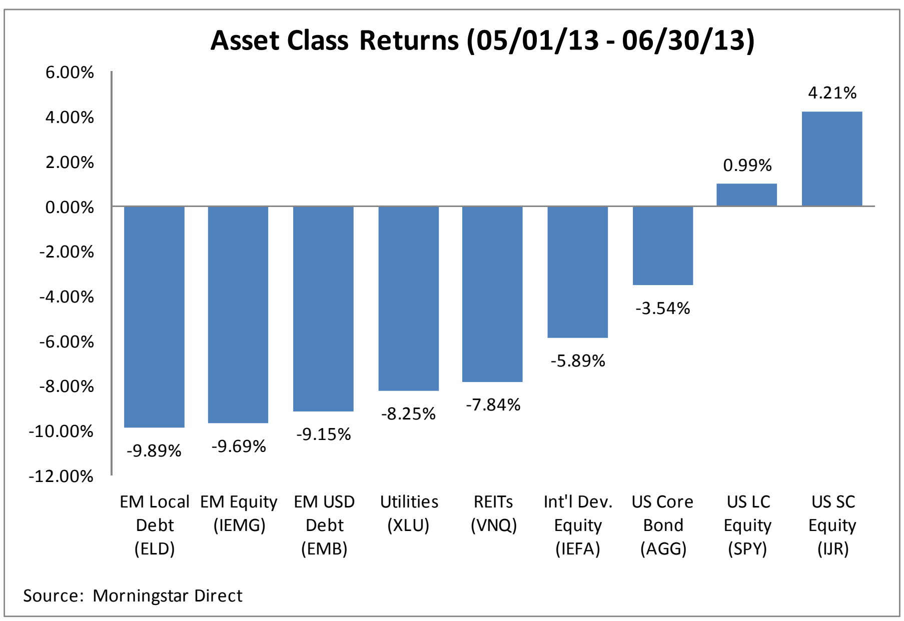
SOME THOUGHTS ON INTEREST RATES

"Be more concerned with your character than your reputation,
because your character is what you really are, while your
reputation is merely what others think you are."
-John Wooden

One of the most heated debates taking place today on Wall Street and within investment management shops far and wide revolves around the timing and potential impact of the Federal Reserve's inevitable tapering of U.S. Treasury and mortgage-backed security purchases. The ramifications and repercussions of this event will likely be felt across the investment landscape and the exact timing of the taper will heavily influence asset class returns in 2014. Given the robust equity market returns realized thus far in 2013, and the uncertainties that lie ahead, forecasters everywhere will be wise to frame their predictions for next year within the context of a highly fluid environment dominated by central bank intervention.

Following Fed Chair Bernanke's first hints at tapering in early May, market prices across asset classes immediately began to adjust. Emerging markets were especially hard hit, but everything from REIT's to utilities, from Treasuries to the U.S. Dollar were impacted. As the chart below indicates, the markets were clearly not prepared for the Fed to potentially act so soon.

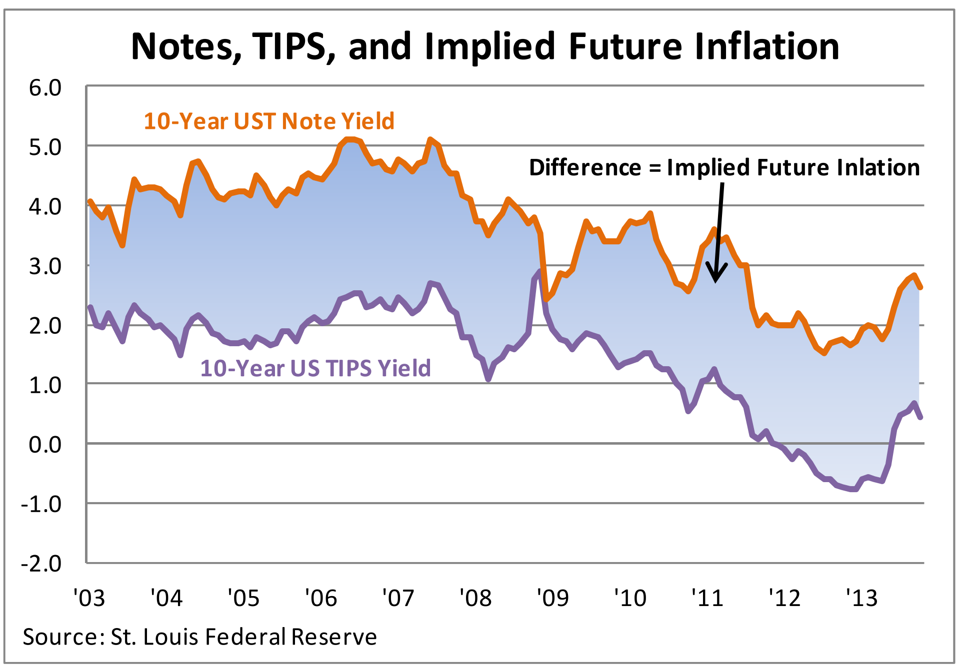


Emerging market debt and equities were especially impacted by the Fed's pre-mature taper-talk. Large amounts of investment had moved into these markets chasing higher returns and the near-term prospects for a more normalized interest rate environment in the U.S. had investors reversing course in a big way. In the U.S., utilities and REIT's suffered as investors priced in higher domestic interest rates, while bonds were impacted modestly as well. The yield on the 10 year Treasury rose from 1.60% in early May to 3.00% by September.

With Janet Yellen set to be named the new Fed Chair come 2014, there is little in her past history that would suggest she will deviate much from the Bernanke script. If anything, the market views her as perhaps more dovish than her soon to be predecessor. Should the Fed continue buying $85 billion per month of Treasury and MBS well into 2014, we'll likely see equity markets respond favorably while interest rates will remain range-bound. If tapering were to begin early in the first quarter of next year, our guess is that we'll see a continuation of the price adjustments first seen this past April.

Given this scenario, the real question in the minds of many is *just what is the appropriate rate of interest in today's market?* For the better part of the last five+ years central banks around the world have been overt in their efforts to manipulate long-term interest rates. While it's the central bank's job to set short-term rates, never before has the Fed printed so much money or intervened in the bond market so aggressively. While the so-called "natural interest rate" may be more a theoretical construct than anything else, the "market interest rate" surely is not. Like the price of most things, interest rates are determined by the forces of supply and demand – in this case the supply of and demand for money and credit. [For more on the natural rate of interest go to http://www.frbsf.org/economic-research/publications/economic-letter/2003/october/the-natural-rate-of-interest/].

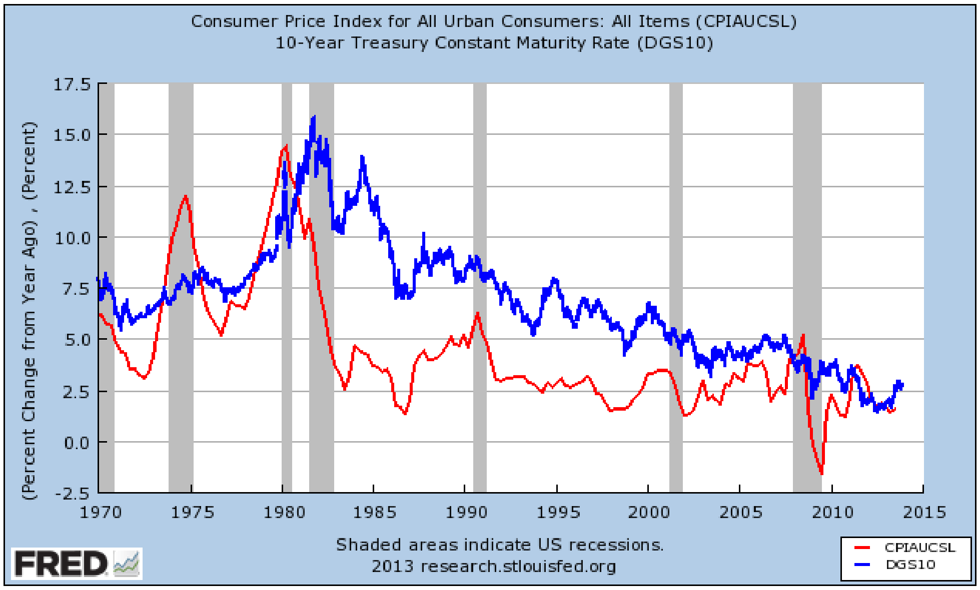
When an investor goes online and looks at market interest rates, what they're seeing is the **nominal rate of return** on bonds in the market. Nominal rates are made up of a **real rate of interest** plus an **inflation premium**. While real interest rates have been somewhat steady over time, the inflation premium has been more volatile. The dramatic move on the 10-year Treasury yield from 1.60% in April to 3.00% in September was largely a change in the real rate of interest rather than a change in expected inflation. The real rate of interest is important because of the impact it has on both investment and business decision-making and it has a tendency to mean-revert over time.



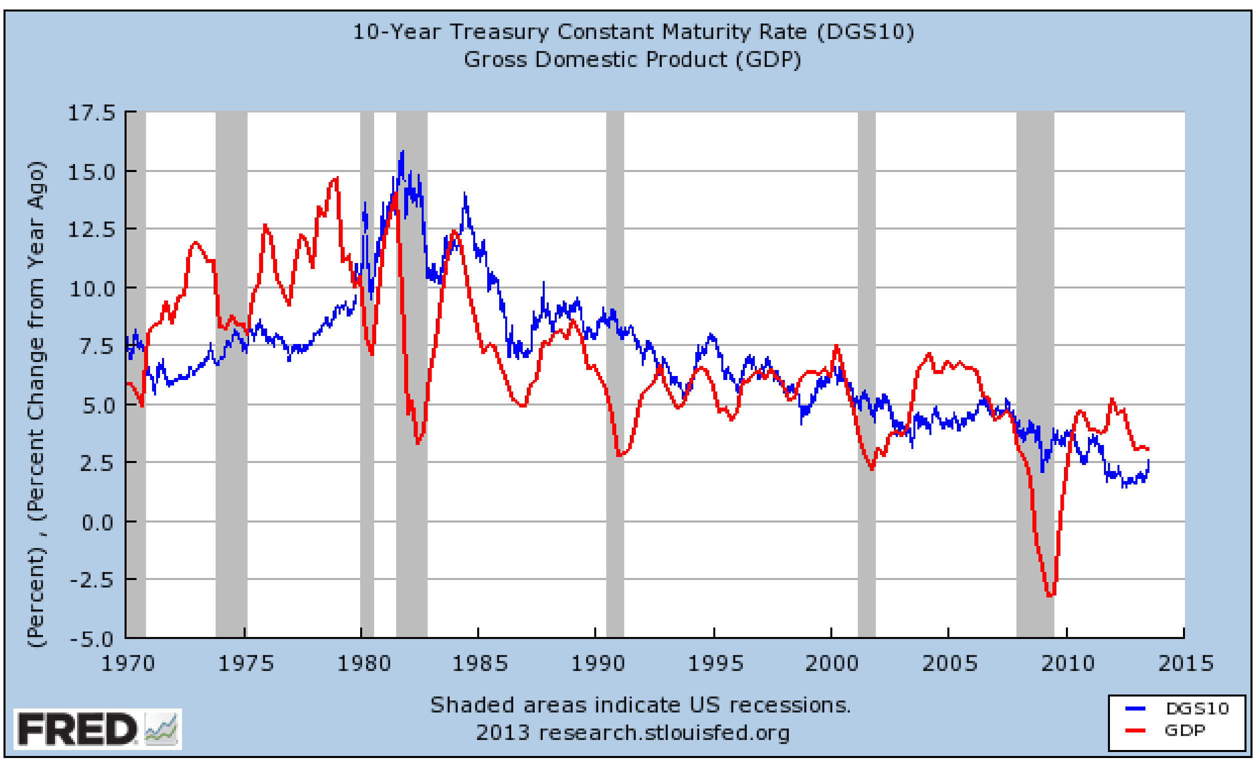
Future inflation expectations are priced into the bond market real-time via the trading of TIPS – Treasury Inflation Protected Securities. TIPS provided owners a real rate of return via adjustments to bond principal based on changes in the Consumer Price Index (CPI). The difference in yield between TIPS and nominal bonds is an implied forecast of the future rate of inflation. Note the negative real interest rates we saw in 2012-13!

The United States has by and large experienced disinflation over the past 30 years, despite a steady expansion of the money supply. Much of the Fed's concern today is over the risk of deflation, a decline in the general price level of goods and services. The following chart illustrates this disinflation, highlighting the relationship between inflation and interest rates. Investors focusing only on nominal rates of interest may end up with negative real returns over different periods of time.

U.S. interest rates have been falling for the past 30 years (blue line) while inflation (red line) has generally declined and, more recently, hovered around its long-term average of 2.5%. Inflation, however, is generally more volatile than broad interest rates as prices of food and energy can change quickly. Note the negative "real rate of interest" we are experiencing as a result of QE.



The nominal 10-year Treasury note yield has roughly tracked annual changes in GDP over time as the chart below illustrates. In other words, the yield on the U.S. Treasury 10-yr note approximates annual changes to nominal GDP. Today's 10-yr note yields 2.72%. In November it was reported that U.S. GDP grew at a 2.8% annualized rate. It would be somewhat unusual for interest rates to rise without GDP rising as well.



In a consumer-driven economy such as that in the U.S., low interest rates and easy access to credit are critical to economic growth. Too much of a good thing, however, can lead to economic disaster, as we witnessed firsthand in 2007 and 2008. A little leverage can go a long way but a lot of leverage can lead to ruin. Although interest rates remain low, easy access to credit has become a thing of the past. Anyone that has tried to refinance a mortgage or borrow from a bank can attest to the fact that things have changed.

While the benefits of continuing QE are clear to us, the argument against maintaining artificially low rates is equally compelling. The benefits of QE have been mainly realized by owners of equities while savers, those whose idea of a risky investment is a bank CD, are being penalized. The removal of QE and the return to market-driven interest rates will go a long ways towards re-establishing some balance in the investment arena and allow for individuals to reduce the amount of risk in their portfolios. As we are in uncharted waters in terms of the Fed playbook, there will invariably be some bumps in the road on the way towards this "normalcy". However, in the long run we will all be better off when long-term interest rates are set by the market rather than central banks. The sooner the Fed unwinds QE, the sooner risk gets more accurately priced in the market.

A Salute to Thanksgiving

I want to conclude this note with a brief acknowledgment of and nod to my favorite day of the year – Turkey Day. When one is fortunate enough to be able to start their day running with their kids in an annual Turkey Trot fun run, follow that up by cooking a simple but delicious meal while watching football, and concluding the day with 25 of their closest relatives for dinner, one can truly say they're blessed. No presents, no department stores, no sales or other hokey holiday gimmicks, just family, food and football. If it weren't for the significant weight gain that would accompany it, I would vote for a Thanksgiving-like dinner every Sunday. Fortunately, my wife is far more sensible than I am.

As it is, the day off gave me time to reflect on a lot of things – equity markets and interest rates among them (yes, bizarre, I admit). In retrospect, we should have seen the huge stock market returns coming given the benign interest rate environment we're in. Perhaps we're still scarred enough from 2008 that we chose to take a cautious stance and hedge against another downturn. As it is, we'll take what we've been given in 2013, it's been pretty good and it's enough for one year. We'll continue to take advantage of low interest rates, refinancing and rationalizing our personal balance sheets so we might weather the next inevitable storm better than the last. And when the time comes for the Fed to taper, we'll be thankful for that to, for all good things must come to an end. On behalf of all of us at Nottingham Advisors, I'd like to wish you a happy and peace-filled holiday season.

Happy Holidays,

Larry Whistler, CFA
President/Chief Investment Officer
December 2013