

Good news for retirees: Low-inflation, higher rates

Rob Rikoon | Posted: Monday, August 5, 2013 9:45 pm

Get ready for the good times. Even though the rich monetary stimulus coursing its way through the world's stock markets will at some point create inflation, this hasn't happened yet. Interestingly, interest rates have moved up over the last month and this benefits savers, most notably retirees.

For nearly five years now, the Federal Reserve Board has suppressed interest rates via its bond buying program and control of the federal funds rate. The bull market in bonds that began in 1981 all but ended this past June. Bond investors reaped great gains during the long period of rising prices — nearly three decades — but they now face significant market risk as interest rates rise. A 10-year bond drops nearly 10 percent in price when interest rates go up 1 percent. Investors who own short-term bonds face a paper decline of about 2 percent for every percentage point rise in interest rates.

Interest rates will rise because that is the only direction they can go. It has become clear to most economists that one of the unexpected costs for continuing to artificially keep rates down is causing the real economy to be stuck in neutral. Today, with ultra-low interest rates, banks do not have to lend money to real companies when they can make similar returns, with almost no risk, by playing it safe and keeping their money in government securities. When rates rise, this will no longer be true as banks will have to pay depositors a reasonable rate of return. This will enable consumers to spend more as well as incentivize bankers to go back to their traditional business of lending money to businesses. Growth in consumer spending benefits cyclical sectors of the economy, in particular energy and technology, while an increase in direct lending to companies should increase employment.

Higher interest rates can hurt companies who depend on large purchases by consumers that need financing. It also negatively impacts utilities and real-estate investment trusts as competition from more traditional bond investments rises. Rising interest rates can lead some investors to exit the stock market for the relative safety of bonds. Companies that have less debt and positive cash flows, two of our criteria for investment, benefit from rising rates as their competitors' costs go up while theirs do not. Many large European companies have lower debt levels than their U.S. counterparts and they also pay high dividends.

There used to be a direct correlation between high interest rates and inflation but that doesn't seem to exist anymore. When Paul Volker raised interest rates to break runaway inflation in the early 1980s, the self-fulfilling expectation of ever-increasing prices was finally offset by the crushing

weight of super high interest rates. This was the start of the bull market for bonds (and stocks) noted above.

We are now experiencing deflation alongside higher interest rates. This has affected the price of gold, mining stocks and natural resource-based companies along with industrial commodities. One reason reported inflation is low is because of increased factory capacity worldwide.

China continues to add plant capacity even though it has already overbuilt its productive facilities in steel, aluminum, housing, and other heavy industrial areas. China needs to keep its workforce employed and the individual profits of the factories are not as important as the Communist Party having the political cover of the illusion of continued economic expansion. This has resulted in decreasing global prices, deflation, for most industrial materials, which should help keep inflation in check.

There are two related sectors of the stock market that I feel will thrive in this kind of environment: energy and technology. They are also the most reasonably priced at the present time. Recent developments of new techniques in energy recovery and advances in hydro-carbon data modeling have resulted in a huge increase in “proven” reserves. The overall outlook for the U.S. economy has strengthened due to America’s emergence as a net energy exporter. Ford recently announced a natural gas set up for retail truck customers which will be the first of many progressive energy technologies that will assist the economy going forward.

Investors in bonds should have more opportunities going forward to earn income, but with greater risk to their capital.

Stock market investors, many of whom have relied upon central bank cheap money to fuel the past few years’ momentum-driven market rallies, need to look more closely at the balance sheets of the companies they own and to shift money into energy and information technology opportunities. If you want to participate in future advances, be aware of the impact of interest rates and deflation on your investment choices.

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