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Jim Grant: Low Interest Rates Forever? Don’t Get Used to That Idea

By James Grant June 7, 2019 6:45 a.m. ET

Illustration by Joel Arbaje

Interest rates tend to change course only once or twice a generation. In 1981, investors could look back on 35 years of generally rising rates. In 2016, a different generation of investors could look back on 35 years of generally falling rates. In bonds, you can profitably spend a whole career not changing your mind.

Humans eat, sleep, and extrapolate. What we think we can foresee is often nothing more than what we have recently seen. “More of the same” is the sensible default prediction in politics, baseball, and interest rates alike. In rates, it actually tends to work.

The other day in Chicago, the Federal Reserve convened a summit to ponder its own operating procedures. The cream of the economics professoriate held forth on interest rates, inflation, employment, and the fine points of policy-related propaganda (styled “communications”).

In his welcoming remarks, Fed Chairman Jerome Powell ventured a forecast. He told the crowd that the next time the federal-funds rate falls to zero—“and

there will be a next time," he pointedly said—"it will not be a surprise."

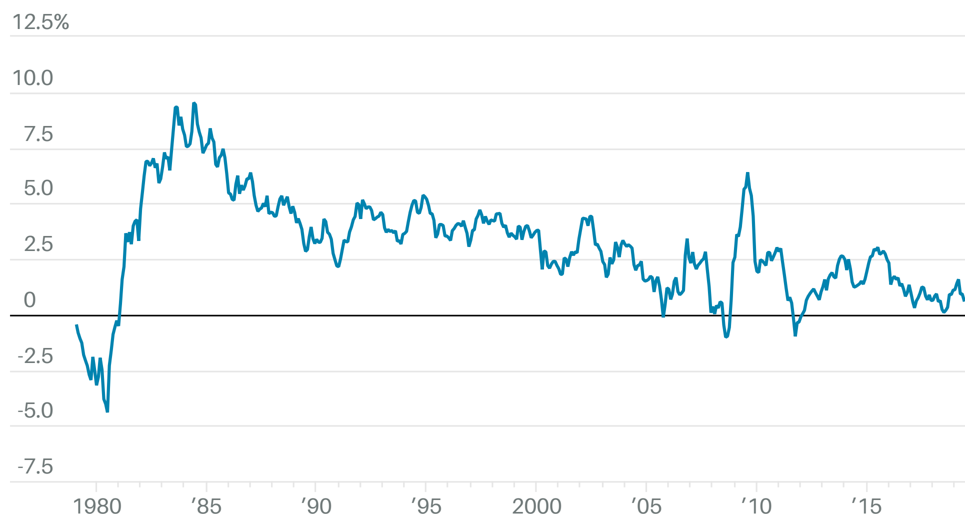
A zero-percent funds rate is a crisis rate. Listening between the lines, you could almost hear the chairman laying down a mental bet on new lows in the 10-year Treasury yield. The standing record, 1.36%, which was quoted at the close of trading on July 8, 2016, had seemed as safe as Ted Williams' .406 batting average.

Who knows? Powell might be on to something. Benchmark German, Spanish, Greek, and Portuguese government yields have lately made new all-time lows, shattering their respective 2016 records. But it isn't the chairman's call per se that commands attention. It's his certitude that grabs you.

No academic economist, the chairman has a practical background in private equity. Now there's an interest-rate-sensitive line of work. Maybe he took to forecasting out of necessity while promoting leveraged buyouts at the Carlyle Group. Or—perhaps more likely—it's muscle memory that gives him conviction. The chairman, age 66, has spent half his life watching rates go down.

Real Yield Shrivels on the 30-Year Treasury Bond

Yield minus year-over-year change in the CPI



Source: Bloomberg

The great bond bear market spanned 35 years, 1946-81, culminating with an astounding 15% yield on the 30-year Treasury. The subsequent bond bull market spanned 35 years, too, 1981-2016. Or it will have coincidentally spanned 35 years if that record-low 1.36% yield on the 10-year continues to stand up as the cyclical nadir. Will it?

Sometimes markets revisit the scene of the crime. From 15%, yields on the long bond tumbled to 10.3% in 1983, but then resumed climbing. By June

1984, they had approached 14%, and eminent authorities declared that the bear bond market was back in business.

The bears had plenty of reasons for so believing, however we may judge the relevance of those reasons today. Among them: the Reagan budget deficits, an allegedly overgenerous Fed, troubles in the banking system (the then-large and prestigious Continental Illinois National Bank & Trust Co. was on the ropes), heavy corporate borrowing, rising commodity prices.

Still, from today's perspective, you wonder what on earth they were thinking about. Lee W. Minton Jr., a Philadelphia bond investor, had the right idea in real time. He observed that, with three-month T-bills quoted at 10%, and with long-dated Treasuries priced to yield 14%, a bond investor could lose four points of principal and still match a money-market return.

Besides, with consumer prices showing year-over-year gains of less than 5%, the real return on a 14% Treasury was nine fat percentage points. It was among the most exorbitant gifts that Mr. Market has ever bestowed on anyone, but a generation stung by falling bond prices turned its back.

Now the generation conditioned by ever-rising bond prices has its hand out. Most of us seem to accept that bonds are intrinsically safe, no matter how little they yield or what money they're denominated in. Today's 30-year Treasury bond fetches 2.65%, while the consumer-price index for April registered a year-over-year rise of 2%. Voilà: a real yield of 0.65%, before tax.

Still, we love bonds as much as our Reagan-era forebears hated them. And we, too, have our reasons: The yield curve is negatively sloped, business activity is dragging, trade tensions are mounting, the price of oil is breaking, and debt is accumulating. Taken as a measure of gross domestic product, nonfinancial debt weighs in at 253% today compared with 156% in 1984. To top it all, the Fed is dropping broad hints of more rate cuts to come.

A bond-friendly belief system filters the news. The April 22 cover of Bloomberg Businessweek features an obituary of the CPI. Chairman Powell characterizes the sub-2% rate of rise in the Fed's preferred inflation metric as "one of the major challenges of our time."

And when President Donald Trump trash-tweets the Fed, we sell no bonds in protest. We'd rather buy them, even the ones that yield less than nothing before inflation (of which novel class of securities there were $11.7 trillion's worth in existence at last report).

If the bulls have momentum, they lack a margin of safety. Even a 4% yield

(never mind a 14% yield) would wreak havoc on a government-bond portfolio. As it is, Germany's 10-year Bund yields minus 23 basis points and commands a price of almost 105. If yields shot to 4%, that safe haven would suffer a 33% loss of principal. Britain's 10-year gilt yields 86 basis points and changes hands at a price of 107. Lift that yield to 4% (a future Prime Minister Jeremy Corbyn might do it all himself) and you are staring at a 24% drawdown in price. Here in America, the same hypothetical yield upsurge would cost you 15% of your principal.

Could it happen? Only consider what people of a certain age have already seen: unprecedented extremes in interest rates, the invention of radical monetary policy, the Republican Party's embrace of the essential tenets of modern monetary theory, the Fed's shift from the Volcker-era doctrine of killing inflation to the post-Ben Bernanke program of nurturing that former scourge, and the shriveling of real yields almost to the vanishing point.

Lower and lower interest rates for ever and ever? It generally doesn't work that way.

James Grant is founder and editor of Grant's Interest Rate Observer. Sample a free issue or subscribe here. His new book, Bagehot: The Life and Times of the Greatest Victorian, will be published in July.

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