MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

Mom—The Squeeze on Your "Income" Will Continue

This essay was originally published in Muhlenkamp Memorandum *Issue 21, January 1992. Ron wrote it as a letter to his mother because he saw that even though the borrowers in our economy were responding to lower interest rates by paying down their debts and refinancing their mortgages, the lenders (like his mother and her friends) were reluctant to accept that the lower rates were here to stay. This essay reviews why interest rates fell, why this was putting the squeeze on retirees, and what they could do about it.*

Since November 1990, you've seen the interest rate paid on one-year bank CDs fall from 8% to 4%. Many of your friends are waiting (hoping) for these rates to go back up, but it isn't going to happen. To understand why, you really need to look no further than the actions of your children. Today your children are paying down their debts and refinancing their mortgages, often for a shorter term.

Most people believe that interest rates are set by banks and savings and loans, but they're really not. Banks normally operate on a 2½% to 3% point spread, so the interest rates that you receive on your savings will be 2½% to 3% less than your children are willing to pay on their borrowings. And the biggest class of borrowing in the country is home mortgages. As these mortgages are paid down more rapidly (15-year mortgages instead of 30-year), the downward pressure on interest rates will continue.

The inflation of the 1970s taught the baby boomers (your children) that a big house with a big mortgage was a good way to make money. It was true for 15 years, long enough to convince us that it is always true. We came to believe that houses were moneymakers regardless of the price we paid for the real estate or the interest rate we paid on the loan. In essence, we believed that as long as we spent our money on real estate, we could spend ourselves rich. We didn't call it spending, of course; we called it investing. And it worked, right up until interest rates went up and inflation came down in 1981. Soon thereafter, falling farm prices cured the farmers of the delusion, but the homeowners continued to hold on to the fantasy—until now.

The Public Changes Its Mind

For the past five years, you have heard and read our arguments in "Wake Up, America—Houses Don't Make You Money!" You have seen our chart depicting the costs of home mortgages vs. house price inflation, which we've been foisting on friends and family alike. What has changed in the past year is that much of the public now realizes house prices don't always go up. As long as people believed that a big house was a good investment (regardless of interest rates) they were willing to pay 10%–11% rates on a mortgage. With the help of the recession, that conviction died in the past year. As recently as November 1990 mortgage rates were still 10½% and CDs were 8%. So this realization and the current incentive to refinance is only a few months old. The incentive to refinance is still "news" and receives extensive coverage in your local newspaper. And any mortgage written in the past 10 years is now susceptible to being refinanced at lower rates.

Conversations with banks and savings and loans indicate to us that only about 20%–30% of eligible mortgages have been refinanced to date. Of these, roughly 20% have opted for 15- to 20-year mortgages (as Sis has done). If this is truly a trend, it has a long way to go, and it will continue to drive rates even lower. Trend or not, you can monitor its progress by simply talking to your children and to your friends about their children. As long as mortgages are being refinanced for shorter periods, the increased monthly principal payments will keep downward pressure on rates. As long as mortgages are being refinanced at lower rates, these new lower rates will be reinforced. Fixed-rate mortgages are refinanced down, not up, which is why many homeowners are now replacing their adjustable-rate mortgages with fixed-rate mortgages.

When you remember that in the 1950s and 1960s, mortgage rates were 4½% and passbook savings were 2%, you get a good idea of where rates may be headed. As recently as 1972, the treasurer of the insurance company where I worked adamantly maintained that normal mortgage rates were 4½%. Each of us who has a mortgage will do our best to drive rates back to those levels.

Meanwhile . . . on the other side of the ledger, you and your friends have seen CD rates drop from 8% to 4%. (I almost said "seen CD rates drop through the floor," but the floor is likely to be on the order of 2%.) This has been a shock to those who had come to believe that "normal" CD rates were 8% (and who relied on such rates for their income). But such high rates were an anomaly of the 1980s. They resulted from the high inflation rates of the 1970s and the baby boomer belief that such inflation rates were normal. I have argued above that inflation and inflationary expectations (in housing at least) have just died. If so, "normal" CD rates may be 2%, and other short-term "riskless" instruments may reach similar levels.

Changing Your Mind

Mom, you said last week that you wouldn't change your lifestyle in response to lower interest rates on CDs. You needn't . . . provided you change your mind about the acceptability of various kinds of investments. For background, please reread our essays from 1989 titled "The Inflation Time Bomb," "Defusing the Inflation Time Bomb," and "What Is Risk?" Be aware that earning good returns on your assets normally requires significant amounts of thought and effort. This is true in farming, and it's true in investing (and in every other endeavor that I can think of). Only in the past 10 years have short-term rates (on no-effort investments) been significantly above inflation, and those days are over.

For over a decade financial planners, advisers, and other experts have maintained that long-term investments (like stocks and long-term bonds) are risky, and that CDs and other short-term debt instruments are risk-free. But their definition of risk looks only at short-term price changes. They have ignored the long-term loss of the purchasing power of your assets, and they've simply assumed, contrary to history, that the high interest rates of the 1980s would continue.

The simple truth is that all investments have risks. There is no free lunch. If you focus too narrowly on short-term risks, you will be vulnerable in the long term. If you focus on the long term, (as we do), you will suffer setbacks short term. My complaint is that many advisers have encouraged you to finance your long-term retirement (for 20-plus years) using only short-term instruments, which were clearly at unsustainably high rates.

These same advisers are now helping your friends buy "longer-term" investments, which they will be called out of as interest rates continue to drop. The most popular has been mortgage-backed securities, which still promise rates of 7½%. But these rates will hold only until the mortgages are refinanced, at which time people will have to reinvest at lower rates, just as you did a year ago. Others are buying corporate bonds, which are also callable, leading to the same problem.

The only investments that allow you to benefit in a climate of falling inflation and interest rates are common stocks and long-term Treasury bonds. By law, Treasuries are noncallable (unless, of course, Congress changes the law). Most other fixed-income investments are subject to call or redemption. Remember, there is someone on the other side of the piece of paper whose job or incentive is to lower his borrowing costs.

Finally, look carefully at your own investing experience. In 17 years of investing in common stocks, you've had one down year. Your annual returns have averaged 15% (9% over the average inflation rate of 6%). So your assets multiplied 10 times, while the cost of living nearly tripled. Has this been so "risky" that you'd rather not have participated?

During this same 17 years, your short-term investments (CDs, etc.) have averaged about 8% (2% over inflation). With inflation, each year your income bought less. In the last year, this income has been cut in half. Has this been "riskless" investing?

Mom, the recent period of high interest rates on CDs is over. It is over because your children are no longer willing to pay an 11% interest rate on their mortgage. So your choices in sustaining yourself through the rest of your retirement have become more difficult. You can still do well, but it will require more thought and effort on your part. You must think for yourself and be skeptical of the conventional wisdom.

Editor's Note

In fact, interest rates continued to fall. As of 2007, fixed-rate mortgages have fallen from 8% to 6%. With help from the Fed, 5% interest rates on CDs fell to 1% before rebounding. Ron considers "normal" to be roughly 1% greater than inflation.