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

Why Did the Fed Raise Short-Term Rates?

This essay was originally published in Muhlenkamp Memorandum *Issue 42, April 1997. The Federal Reserve had just raised short-term rates in response to fears of inflation. Some people expected inflation because the GDP was growing, and Keynesian economic theory says that GDP growth causes inflation. The opposing school of thought, Classical economic theory, says that printing money causes inflation. Since in 1997 the GDP was growing but the government wasn't printing money, it was a good time to take a look at the two theories.*

Recent Fed actions coincide with the debate in economic theory over the root causes of inflation. In each newsletter over the past year, we have related this debate to you, and it continues to command center stage in the stock and bond markets. Six months ago, we wrote:

> The debate is, "Does Economic Growth Cause Inflation?" Keynesian economic theory says growth causes inflation. Classical economic theory says that only the printing of money causes inflation. If you took economic courses 30–40 years ago, the odds are very high that you were taught the Keynesian theory (that growth causes inflation). I took these courses, and that is what I was taught (I'm 53). Most of the people who are now "chief economists" were also taught this theory. Economic history of the last 30 years has demonstrated that growth doesn't cause inflation. Specifically, the changes in policy by Paul Volcker and Ronald Reagan in 1979–1982 demonstrated that money growth, not Gross Domestic Product (GDP) growth, causes inflation. But the evidence has not caused many economists to change their minds.
>
> More recent refinement of the theory states that growth greater than 2½% per year will result in increased inflation after a time lag of about 18 months. We have now had GDP growth exceeding 2½% for 18 months (which is why the issue is front and center). So the Keynesians have been expecting increased inflation and have predicted higher interest rates as a result. Specifically Morgan Stanley's chief economist has been predicting long-term U.S. Treasury rates of 8½% by year-end 1997.

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Conversely, at Donaldson, Lufkin and Jenrette (DLJ), their chief economist is predicting long-term Treasury rates of 4½% by year-end 1997 (based partly on a belief that growth doesn't cause inflation and partly on his forecast of a recession in 1997). Folks, that is a huge difference! If rates go to 8½%, a 6% 30-year Treasury which was priced at $1,000 on 12/31/95 would be priced at $740 at year-end 1997. If rates go to 4½%, the same 30-year Treasury would be priced at $1,230. Similarly, the S&P 500, which was priced at 620 on 12/31/95, would be likely to sink to 550 or soar to 850 by year-end 1997. So the outcome is far more than academic.

An interesting sidebar is that these predictions were both made in early 1996 with a horizon of nearly two years. Two years is a short time in economics but a long time in the stock and bond markets. Two years is ample time for the markets to swing one way based on hope or fear, and then to swing the other way based on reality.

During the first half of 1996, the yield on long-term Treasuries rose from 6% to 7¼%. The price fell from $1,000 to $850. We believe this move was based on a fear of inflation in concert with the Keynesian theory. Evidence for this includes a 2% drop in bond prices and stock prices on July 5 when the government reported GDP growth for the second quarter of 4.6%.

Through the first nine months of 1996, the reported economic numbers have been mixed enough that neither economist saw a need to change his forecast—until now. The first change occurred on October 4, when in response to lower employment numbers (and an up-tick in the unemployment rate), the economist at Morgan Stanley shifted his GDP growth prediction to 2% in the third quarter and 4% in the fourth quarter (from 3% in each quarter) and lowered his interest-rate ranges for 1996 from 8%+ to 7¼%+. That day, the bond market jumped over 1% and the stock market rose 1%. The numbers for the remaining months of 1996 will be key to determining which theory is accepted. We believe the Classical theory (growth does not cause inflation) will be affirmed once again, that interest rates will decline, and that the stock market will do well with a focus on individual stocks. Stay tuned.

Since we wrote the preceding in October 1996, GDP growth has been greater than forecast, with the fourth quarter up nearly 4%, but without an increase in reported inflation. Nevertheless, the strong GDP numbers renewed the fears of inflation, resulting in renewed pressure on the Federal Reserve to raise short-term interest rates. The Fed raised rates by ¼% on March 25, 1997. The Fed labeled the move "preemptive."

The strong fourth quarter also resulted in DLJ's economist extending his projections out three to six months, but he did not change his conclusion. Morgan Stanley's economist has also extended his prediction. So now both economists have extended their time periods, but neither has changed their (diametrically opposed) forecasts. The strength in GDP and the fears of increased inflation have also moved the rates on long-term Treasuries to a range of 7.10%–7.15%, up from less than 7% at year-end, but still below the 7¼% reached (three times) in 1996.

Normally we don't worry much about a difference in interest rates of ¼% to ½%, and frankly we don't think current changes of this magnitude will have much effect on the economy. But in the current environment of well-balanced growth and fair stock prices, many market participants have focused on Fed actions and long-term interest rates as bellwethers for the next short-term move in the markets. In short, today the perceived signal may be more important than the reality.

Since WWII, each recession in the U.S. economy has been preceded by an increase from the Fed in short-term interest rates (although not all increases have been followed by recession), and each major decline in stock prices has also been preceded by an increase from the Fed in short-term interest rates. We believe we must respect this history and the Keynesian theories (and the amount of money responding to the theory) until we see further evidence (and they see evidence) that inflation is not increasing.

Two things that we are watching closely are long-term interest rates and the public's purchase of housing. Long-term interest rates directly reflect the fears of inflation. The reason the Fed raised short-term rates is to quell inflation and inflation fears, which should ultimately drive long-term rates down. When the Fed raised rates in March by ¼%, rates on long-term bonds, which are determined in an open market, went up by roughly 1/8%.

The people who buy houses make their decisions partly based on the mortgage interest rates, which usually move parallel to other long-term interest rates. Since 1990, our observation has been that when mortgage rates exceed 8% (as they have just done), the public reduces its home purchases. Should it do so once again, long-term rates won't go much higher.

Meantime, we continue our normal course of identifying companies we would like to own, setting prices at which we like to buy their stocks, and investing some of our cash when those prices are met.

2005 Update

The top plot in Figure 6.23 illustrates the growth rates of Gross Domestic Product (GDP) and the Consumer Price Index (CPI)—inflation; in the bottom plot we've added interest rates on 3-month Treasury bills (short-term rates), 20-year Treasury bonds (long-term rates), and 30-year mortgages. As you can see, the argument in 1996–97 was merely a preamble to 1999–2000.

In 1997, despite GDP growth consistently above 3%, inflation did not pick up, but fell (contrary to Keynesian theory). This drop in inflation allowed long-term rates to fall to 5½% by the end of 1998 (although not to the 4½% predicted by the DLJ economist). Mortgage rates fell in concert with long-term Treasury rates.

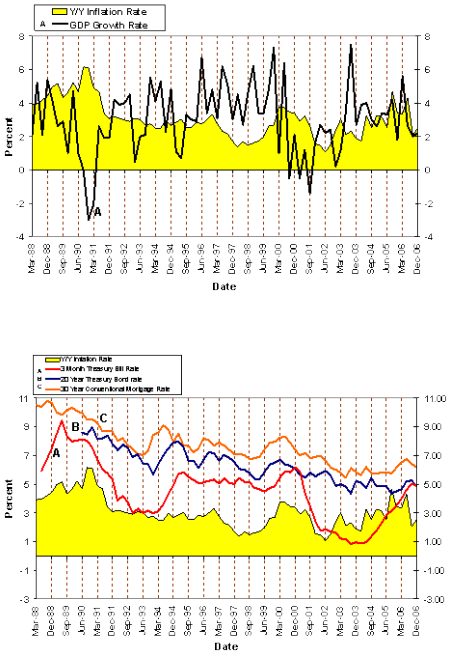
In 1999, inflation did rise, causing increases in long-term rates and mortgage rates. In response to the rise in inflation, the Fed raised short-term rates through 1999 and early 2000. Then, as GDP growth declined, long-term interest rates rolled over and headed back down, while short-term rates and inflation continued to rise. Let me explain why. In 1999, Alan Greenspan, the Fed chairman, all but said that he'd take a recession rather than allow inflation to increase. So, once the markets concluded that the up-tick in inflation was not a cause for alarm (the Fed was not going to let inflation get out of hand), long-term rates (which are determined in the marketplace) headed down, while short-term rates (which are heavily influenced by the Fed) were still rising. Mortgage rates followed long-term rates, although they lagged a bit at the time.

It has been eight years since this essay was written, and inflation—after an up-tick in 1999—has stayed in the 2%–3% range. The Fed did what it said it would do: it has controlled inflation. Long-term interest rates have, in fact, dropped to the 4½% levels predicted by the DLJ economist.

So what do we learn from this? First, Classical theory (which says that excess money supply is the cause of inflation) has been a better guide to understanding inflation and interest rates than Keynesian theory. Second, on a monthly basis, the economic data that investors see move around a lot, giving ample opportunity for short-term swings in the bond and stock markets. So, unless the investor has a long-term perspective and conviction in which economic theory to follow, it's easy to get whipsawed in the markets. Third, hindsight can be deceptive. We need to remember that investing is a real-time pursuit, and that the investor does not have the luxury of hindsight when making investment decisions. With hindsight, we

know that the actions of the Fed in 1997 were a non-event. With hindsight, we know that the actions of the Fed in 1999 heralded a recession. But *at the time*, how would an investor be able to judge the significance of what was going on? How would an investor know who to listen to? That is why the successful investor needs to have a core understanding of how the economy and the markets interrelate. Then, he or she can hold steady in the midst of the debate and not get whipsawed by the market.

Figure 6.23 Inflation, Growth, and Interest Rates, 1988-2006



Source: Bureau of Economic Analysis, U.S. Department of Commerce (GDP Growth Rate); Federal Reserve Bank of St. Louis (20-Year Treasury bond)

2007 Update

Refer to our essay titled "Where to from Here?"