# Raise the Rates and Slow the Economy- Housing Gets Hit First

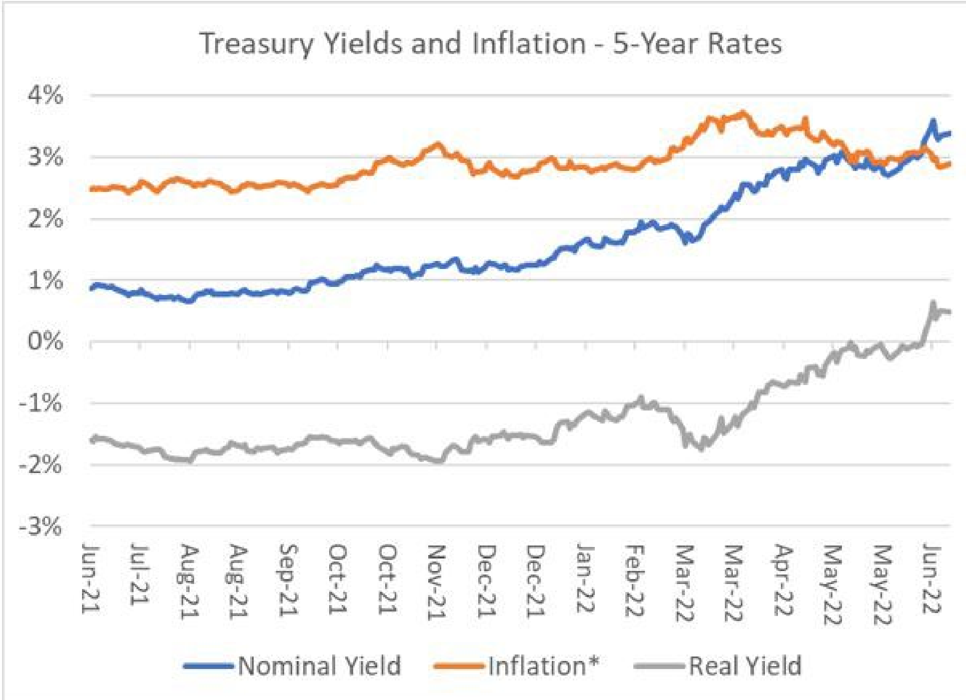
June 23, 2022

Investors looking to put new money to work in bonds have reason to cheer. It's now possible to get a positive inflation-adjusted return on Treasury bonds. Imagine that! We no longer have to lose purchasing power when we lend money to the US government! Aren't we lucky!

First a quick refresher. US Treasury bonds are considered "risk-free" assets because it is almost impossible to foresee a scenario whereby the US government might default on its financial obligations. While anything is possible, the government can simply increase tax rates, in a worst case scenario, to generate sufficient tax revenue to cover debt service. Having said that, Treasury bonds do carry risk, and some investors are now finding that out the hard way. The risk inherent to owning Treasuries is called interest-rate risk. When you buy a Treasury bond, you are paying for a series of fixed payments, both interest and principal, to be received in the future. If market interest rates were to rise, the value of that fixed payment stream would decrease (and vice versa). So in owning Treasury bonds, especially those with maturities far out into the future, you are effectively betting that future increases in market interest rates will be limited. If you didn't believe that you would simply wait for market interest rates to rise and then buy the bond. Indeed, many investors who purchased long-term Treasuries last year wish they'd waited until now. This was the argument for buying higher coupon, shorter duration bonds in FMW portfolios.

Now, we can break down the interest rates paid on Treasury bonds, which are called "nominal" interest rates, into two components. There is the inflation rate, and there is the "real", or inflation-adjusted, rate. The nominal rate is simply the sum of the inflation rate and the real rate. In normal times, investors would expect to earn a nominal rate of interest high enough to both recover all of the expected inflation over the life of the bond as well as earn an additional return to compensate for the use of an investor's money. Another way of saying this is that the real rate should, in normal economic times, be positive.

Over the past couple of years, though, the interest rates available on Treasuries have been insufficient to cover expected inflation, let alone the additional compensation usually expected. In fact, if you had bought a 5-year Treasury bond as recently of March of this year, you would have been locking in a loss of nearly 2% per year after inflation. But, as the chart below shows, real yields, depicted by the gray line, have finally crept into positive territory. The nominal yield on the 5-year Treasury bond has risen to 3.38%, which is enough to cover expected inflation of about 2.88% along with an additional yield of about 0.5%. Hey we're getting somewhere!




Sources: Bloomberg and FactSet.

There is one last element to discuss, and that's credit risk. As mentioned above, US Treasuries are perceived to have no credit risk thanks to the government's ability to generate tax revenue. All other bond issuers must pay a premium to the rates available on Treasuries, which is referred to as the "credit spread." This is the additional yield necessary to compensate investors for the possibility of a default. Credit spreads can become very small at times, usually for quality issuers in good economic times. Credit spreads can also become quite large, and that usually happens to issuers of lesser quality and in bad economic times. In the chart below, I show the recent trend in 30-year fixed-rate mortgages (blue line), along with the trend for 10-year Treasury bonds (orange line), which is considered the benchmark for 30-year mortgages because the durations are similar (beyond the scope of this email). The gray line is the difference between mortgage rates and 10-year Treasuries, and you can see that that spread has nearly doubled from its low in mid-2021 to over 2.5% today. This increase in spread could reflect a number of factors, but the most likely are that the appetite for owning long-duration assets like mortgages has declined materially (due to rising inflation and interest rates) and fears of a recession, which would lead to more stringent lending standards. The take-away from this is that anyone looking to take out a mortgage these days must not only pay the higher benchmark rates (10-year Treasury) but also the sharp increase in the credit spread. No fun!


Sources: Bloomberg and Freddie Mac.

The return of positive real interest rates is a very welcome development for savers and investors. Assuming inflation rates come down from the current breakneck pace as expected (which may be a big "if"), those with money to put away can now earn a return sufficient enough to cover increased living expenses. However, the sharp increase in interest rates this year is also the nail in the coffin for many prospective homebuyers who were hoping to lock in a low mortgage rate. I read a statistic over the weekend from John Burns Real Estate Consulting and quoted in a piece by John Mauldin. The group estimates that the increase in mortgage rates from 3% to 6% translates to 18 million fewer households that can now afford a $400,000 mortgage – a stunning decrease of 36%! If the Fed was targeting the housing market, it sure hit the bullseye. And housing is just one of the many sectors of the economy that have become dependent on cheap and plentiful capital.

The huge backup in interest rates is sure to have profound economic consequences, some positive but most negative. The good news is that barring sustained rates of intolerable inflation, the markets have done most of the heavy lifting for the Fed. It is also a welcome development that fixed income has become an investable asset class again, with yields that not only compensate for inflation but that are also competitive to the returns available from many equities (at least for a period of time). It's way too early for the Fed to declare victory, but the capital markets, for the most part, are acting in predictable fashion so far. Let's hope the transition remains orderly and constructive.

Peace,

Michael

**Disclosures**





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