



Saturdays with Jim: Beware When Inflation And Interest Rates Rise

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Beware of this or that is seen on signs and heard in sayings. But what does it really mean? It's short for "beware." Be attentive, that's all "beware" means. But there is a big question mark implicit? Beware of what, and why?

Today let's discuss why we should be wary of a not imminent but eventual rise in interest rates (the cost of money) and inflation (the erosion of purchasing power). We have with us our favorite economist-philosopher, John Maynard Keynes (1883-1946). Dr. Keynes lived through the largest inflation in modern times (Germany in the 20's) and the most devastating deflation perhaps ever, during the 1930's. He also lived through the most destructive war in history, the Second World War. Dr. Keynes is eminently qualified to discuss today's topic.

Gaia: Welcome, Dr. Keynes

JMK: Thank you, Gaia. Today's topic is probably the single most important one your readers will see all this year, perhaps ever.

Gaia: Why is that?

JMK: Your clients are all investors. That is, they are seeking a return on their invested money in excess of purchasing power. Furthermore, they are either investing for eventual income in some sort of retired life or they are already retired. In either case, they are concerned about the quantity and quality of income they will eventually receive. As many have quit or have drastically reduced gainful employment, they have become more dependent on their investments' ability to sustain them according to the lifestyle they choose. Dependent on passive income, they naturally are concerned that the purchasing power of their income not be eroded over their expected long life span - most likely to be in the high 90's for many if not most.

Gaia: How would you describe inflation and interest rate movements in the last, say, 30 years to today?

JMK: Inflation (often defined as too much money chasing too few goods) peaked in the late 1970's and has been declining until 2009, when it actually went negative in some places. Similarly, interest rates, which tend to lag inflation a bit, peaked in the early 80's and fell until they hit lows in 2003 (corporate bond interest rates) and in

2009 (government bond interest rates). Interest rates tend to follow a 54 year cycle, give or take a few years. Half of the cycle is 25-30 years. If you believe that long-term cycles tend to repeat, and I do, then we have probably seen the current cycle lows in interest rates in the past few years.

Gaia: Do you see rapid rises in interest rates any time soon?

JMK: Probably not. It may be several years before rates in general rise far above where they are now. However, short-term rates will likely rise somewhat, as they are controlled by governments. Rates have been kept low to stimulate economies. Rates are not likely to rise generally because deflationary forces arising from over-indebted consumers in developed countries are and are likely to remain very strong for years to come. Offsetting the drop in consumer spending are governments "priming the pump." But governments are not in the prettiest of fiscal positions either, and there are practical limits to their borrowing power. In short, inflation and high interest rates are likely to be still some ways off.

Gaia: And in the meantime?

JMK: We will see a lot of backing and filling, as we saw in the 1930's. We may see steps forward, steps back for some time to come. I would recommend that you position your clients flexibly. Don't get married to any one investment or investment style for very long, as change could be rapid. Be diversified and defensive, guarding the nice gains you made in 2009.

Gaia: Should we focus more on income or on account balances?

JMK: A good question, as the two can sometimes seem to be in conflict. I would recommend that you focus on balances first, as volatility can present some opportunities for you to build income. For example, we are likely to see some double-digit gains and losses in security prices in the months and years ahead. You can take advantage of them by selectively buying and selling. Doing so will eventually increase income, but temporarily at least the movement of your capital may depress income a bit. Remember, your clients see their account balances almost constantly, but they see the production of income only more slowly and in a less direct fashion.

Gaia: If inflation and large interest rate rises are not likely to be a problem for some time to come, what is the correct investment stance for income investors?

JMK: Position your clients in quality, wherever that may be. Focus more on the U.S. than you have been these past few years. And don't be too concerned about a gradual resumption in short-term interest rates, so long as longer-term ones (5 years or more) do not rise in concert.

Gaia: Why is that?

JMK: Long-term rates are not set by central banks - they are set by supply and demand forces in bond markets. The major risk a bond investor faces beyond the risk of being paid is the risk that inflation may eat into the income the bonds provide. Rising interest rates, then, are the market's way of saying that they want more compensation for risk.

Gaia: Do you have a closing remark to make, Dr. Keynes?

JMK: Yes. The current environment is, in my opinion, what the 30's could have been had governments and central banks reacted properly by lessening monetary and fiscal purse strings. In my opinion, governments and central banks have indeed done the "right" things in the most recent crisis, but it remains to be seen what the long-term effects will be of exploding government debt. Democracies in general do not have a great history of acting proactively in non-crisis mode. Let us see if the democratically elected governments of the developed world, the center of the financial maelstrom, can pull together quickly enough to avoid either serious social unrest brought about by severe fiscal tightening or inflation or will try to spend themselves out of the crisis by printing

money. I think that prudence will win the day, but don't expect the path ahead to be free of serious obstacles.

Gaia: Thank you, Dr. Keynes, for visiting us once again. It is always a pleasure.

JMK: You are welcome, Gaia. As small and as insignificant as you may seem, you are doing one of the best jobs of shepherding client resources that I have seen. Were I alive today, I would not hesitate to recommend your firm to friends and colleagues.

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