

Just how high could Long Term Interest Rates actually go?

The standard opinion is that long-term rates (e.g. 10-year) and not short term rates are most relevant to the pricing of commercial real estate. The current consensus is that short rate will rise to 2.2% and the US 10-year will “settle” in at 3.2% over the next few years. Let me offer up some thoughts on the factors that have governed the relationship between these two rates historically and suggest a new one for the future.

#1: Short term rates. There is no doubt that long term rates certainly embody short term rates. That said, the two certainly do not move anywhere near proportionately. Despite being positively correlated over the last 20 years, the premium of the 10-year has ranged from zero (in 2007) to 3.5% (in 2004). Its average is 1.5%. If you ask me to predict the 10-year rate in 2020 – it will depend more on the shape of the yield curve than the (then) short rate itself.

#2: Normal movement in the Government yield curve. One of the most intuitive theories is that the long rate is the present discounted value of *expected future* short rates over its term. When the yield curve is nearly flat (2000, 2007) markets expect significant falls in the short rate. When the curve is steep (2004) the market anticipates future rate increases. Hence if we think that the short rate will rise to 2.2% *and then stay there* (the consensus forecast) then the long rate might settle at its average premium of 1.5% - giving us 3.7% for the 10 year. The problem is that with paired fluctuations in GDP growth and inflation, the short rate never stays in one place for very long. So if the next 5 years, brings us labor shortage wage increases, import restricted goods inflation, larger deficits, the resulting CPI inflation may lead the Fed to raise rates above 2.2%, generating an economic slowdown, which will bring short rates back down again.

#3: Abnormal movement in the Government yield curve. Over the last decade, central banks in many countries hit the “lower (zero) bound” for short rates in an attempt to recover from the Financial Crisis. While some tried charging negative rates for parking money safely, the US Fed engaged in asset purchases of long term Treasury and Agency debt – to the tune of 4.5 Trillion. This “Quantitative Easing” led to a 1.5% drop in the long rate (against a zero short rate) between 2011 and 2014. Going forward, however, most central banks are now considering “unwinding” – or the sale of these acquired assets. Even if done cautiously, could this not add 1.5% back into the slope of the yield curve for a number of years?

#4: Changes in the Demand for and Supply of investment capital. Most countries are now entering a period wherein their population significantly “ages”. With this demographic change, household savings rates should drop significantly. They already have in Japan – the first nation to experience aging. And on the other side of the market, the demand for investment and capital should only grow. Under-funded public pensions can supply the growing pool of elders only with further government borrowing. There is widespread belief that the infrastructure of developed countries needs a serious infusion of capital. Finally, climate change will drastically increase investment just to mitigate its impacts. The IEA estimates additional investment of 1 trillion annually to evolve the energy system over to renewable sources. Many trillions additionally will be needed to develop flood control systems, redesign cities, and move populations away from coastlines. An inward shifting savings schedule and outward shifting investment demand can only raise rates.

Let's take stock. A short rate of 2.2%, plus a normal 1.5% long term premium, plus another 1.5% from "quantitative unwinding", plus the start of long-term Climate-plus-Aging capital requirements gives us a 10-year of just 3.2? Doubtful. .