Interest Rates:
Where Are We In The Big Picture?

ADVANCED ASSET MANAGEMENT ADVISORS

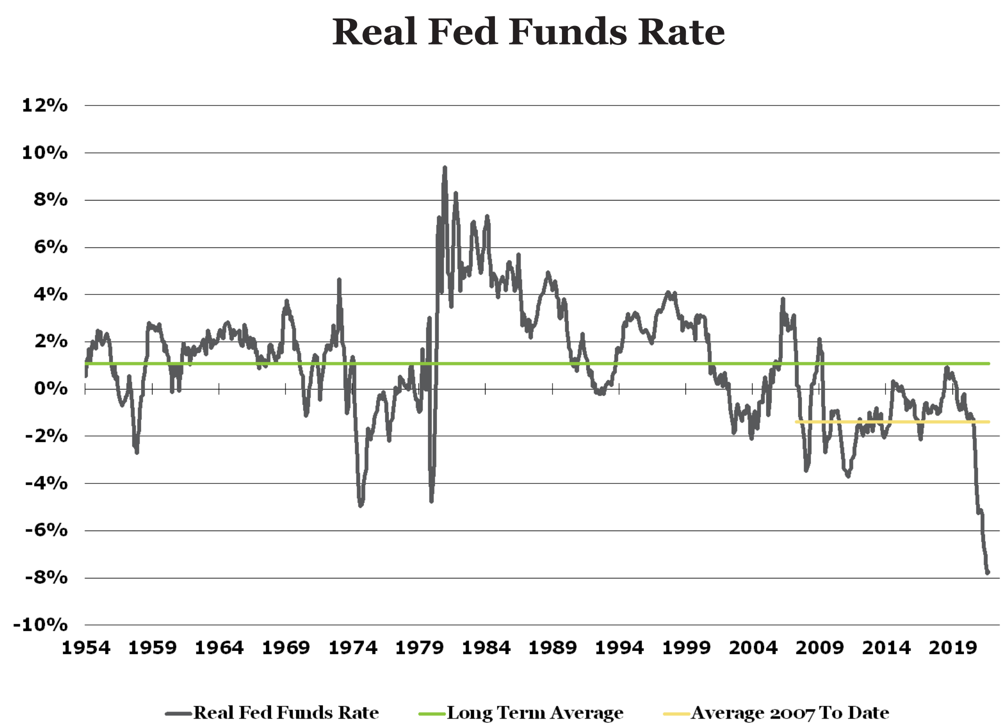
Rates have been moving higher – for everything and everywhere. Where will they go from here? Not to be flippant, but it depends.

From an empirical standpoint, the Fed is clearly "behind the curve" - meaning they have been late to the inflation fighting process.

To be fair, there are some "transitory" contributors to inflation, but they have been lost in the tsunami of other factors—a ten-fold increase in the Federal Reserve balance sheet, massive growth of the money supply, extraordinary elevation of transfer payments, supply chain disruptions and repatriation, to name a few. The war in Ukraine has further impacted global energy and food prices.

Some of these contributors can be directly influenced by Fed policy, others cannot.

We have written about the Federal Reserve's hesitation to address inflation early in this trend. Now, the Fed seems committed to the fight. But what have they done and what will they do? So far, they have increased the target for the Federal Funds Rate from 0.13% to 0.83%. While seemingly significant, this still leaves the "Real Fed Funds Rate" (rate less inflation) at the lowest level in history.



Fed Action In Other High-Inflationary Periods

We've seen periods of a sharply negative Fed Funds Rate before.

The first episode was 1975 when the Fed cut rates by half to bolster the economy after the 1973-74 energy inflation shock. Inflation eventually subsided. The second episode was in 1980 when inflation briefly overcame a 10% Fed Funds Rate. Paul Volcker squashed inflation with a 20% Fed Funds Rate. Since October 2007, the real Fed Funds Rate has averaged **negative 1.4%**. Longer term, the average is positive 1.1%. It is reasonable that the shortest risk-free rate should average a bit above inflation.

Where rates go from here "depends" on where the Federal Reserve's allegiance lies. Chairman Powell recently acknowledged (nearly apologizing) that inflation has decimated the value of wages. He also acknowledged (nodding to wall street), that "markets are going to be sensitive to it" as he discussed plans for the balance sheet.

Inflation harms lower income households the most. Fighting inflation harms higher income households more as asset values typically decline. The Fed is walking a thin line as it shoots for a "soft landing". That thin line also delineates the relative benefits of preserving the average person's purchasing power vs. preserving asset values.

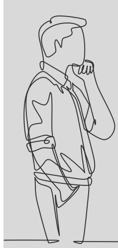
"Normalizing" both interest rates and the balance sheet would be a shock of enormous proportions. Normalizing the balance sheet would require the sale of $6 Trillion of bonds. Normalizing the Fed Funds Rate would require a nominal rate of 9%.

We seriously doubt they would even contemplate these actions. If they did, long-term Treasury bonds could face significant additional losses and stocks would probably trade at 6 to 10 times earnings. We remember those times back in the 1970s and 1980s.

What We Expect From Interest Rates In The Immediate Future

For the immediate future, we expect rates to continue higher for everything and everywhere, until the Federal Reserve decides that wall street has suffered enough… or if it perceives that continued carnage in the bond market is too devastating to main street as the value of pensions and 401K balances shrink. If the market perceives the Fed is going too far, longer dated maturities will perform better as a potential recession is priced into the market.

Credit spreads have widened during the bond market sell-off. This is a function of rising concerns about corporate resilience as recession risk is rising. Recessions bring higher default rates. In the aggregate, investment grade corporate leverage and liquidity ratios are good, which should cushion further widening of credit spreads. However, there can be a "tipping point" if a severe recession becomes priced into the markets.



Did You Know?

The Bloomberg Barclays Aggregate Bond Index's first quarter 2022 return of -5.93% was the third worst since inception its inception in 1980. The worst was -8.71% in the first quarter of 1980. The second worst was -6.56% in the third quarter of 1980.

Interestingly, these two records bookended the index's best return of +18.78% in the second quarter of 1980. The record gain in the second quarter of 1980 presaged the double dip recessions in 1980-1982.

The Bottom Line On Interest Rates, Yields, And Our Portfolios

Even with the increase in rates to date, risk adjusted yields do not properly compensate for the risk of loss in longer maturities or lower credit quality. AAMA's fixed income strategy targets high quality issues and a relatively short average maturity of approximately three years. While not identical to any particular index, our fixed income portfolio can be similarly compared to the 1-3 Year Treasury Bond Index—except with a target average maturity approximately one year longer than the index.

	U.S. Agg. Bond (AGG)	High Yield Bond (HYG)	TIPS Bond (TIP)	20 Year Treas. Bond (TLT)	1-3 Year Treas. Bond (SHY)
30 Day Yield	1.9%	4.3%	6.7%	1.8%	0.2%
12 Month Yield	1.7%	4.2%	6.0%	1.7%	0.3%
3 Year Vol. (Annualized)	4.66	8.94	4.62	15.20	1.58
15 Year Vol. (Annualized)	3.99	10.84	5.65	13.96	1.36
Current Duration	6.52	4.33	7.29	18.27	1.9
YTD Total Return	-9.43%	-8.72%	-5.19%	-19.05%	-2.99%

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