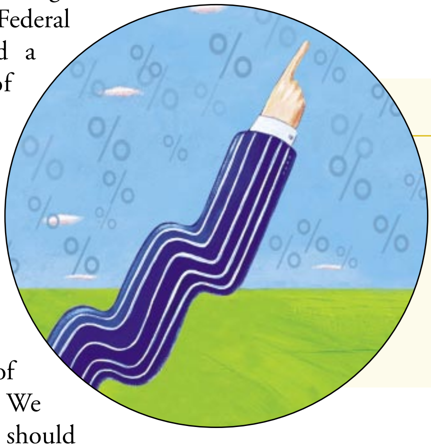
LEADING INDICATORS

Prepare for Ripple Effects from Higher Interest Rates

[by John Kightlinger]

Just about everyone on the planet expects U.S. interest rates to rise. As this article goes to press, more economic data will have been released that should confirm positive growth in the economy.

Longer yields have already increased in the past month, after trending down for the last seven. The Federal Reserve has maintained a 10-month period of steady short term interest rates but is beginning to walk a fine line as it tries to hold the recovery in place and cajole market participants into believing higher rates are probable and can be a sign of better times ahead. We believe bond investors should be aware and have cash reserves.



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Should we fear higher interest rates?

Yes, because as with any change, corporations and bond investors may not be prepared. Selling causes bond prices to fall, creating higher interest rates and a better opportunity for investors. But when interest rates rise, some bond and corporate managers may need to quickly reduce exposure to complicated transactions that have been enabled by low cost short-term rates. Adjustments may cause market strains.

Politics: It's mostly about jobs.

With the national conventions at hand, political posturing will be even more intense. Because the economy reacts with a lag to low interest rates and tax incentives, neither party can change its course prior to the November election. The war news may get worse and has become a huge imponderable.

Slow employment trends have complicated variables. For example, businesses can write off costs of new equipment if installed this year, which is one of many reasons for the hesitant jobs growth. We recommend a large dose of skepticism toward most of the immediate solutions encapsulated in 30-second political commercials.

Higher inflation expectations are raising interest rates. Economists theorize so-called core consumer prices that deduct food and energy more accurately reflect inflation price trends. That's the theory, but we know consumer psychology and cash flow can be dramatically changed by swings in food and energy. The "core" CPI, excluding food and energy, is up 1.6 percent for the last 12 months ending in March. It was up 1.1 percent for the 12 months ending in December. It would be logical for a bond investor or a lender to believe this rate is trending to at least 2 percent, and thus demand a higher yield for new purchases. That's one of many reasons why 45-year low interest rates were not sustainable.

Don't blame the cows.

Even a carbohydrate counter may find this interesting! The milk consumer is a victim of odd circumstances occurring in virtually every stage of milk production. This includes a key hormone in short supply, higher feed grain costs due to last year's drought, farmers not able to easily increase supply or add livestock because imports are closed from Canada due to last winter's mad cow scare, and increased packaging, refrigeration and transport costs due to higher petroleum prices. Economists may not care, but we guess consumers and investors do.

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