

Investment Outlook

Interest Rates Trending Up?

It's hard to see how interest rates can go any direction but up.

The Consumer Price Index is up 5.6% for the year ending July 2008. The monthly CPI increase was 1.1% in June, followed by 0.8% in July. August CPI will benefit from falling gasoline prices, but the Fed is continuing to feed inflation by growing the money supply at a rate far above the economy's growth rate. Falling housing prices do not help the CPI; since 1983 the CPI housing component has been based on rents, not property values, and rents have been increasing at a goodly clip, despite the glut of vacant homes.

Interest rates are currently below the rate of inflation. Historically, this situation has never persisted for any length of time. So if inflation remains at current levels, we should see a climb in interest rates.

Suppose the Fed gets serious about fighting inflation and stops pumping money into the economy. What then? Certainly in the short term, tightening the money supply will raise interest rates. In the long run, interest rates may decrease as inflationary expectations abate.

The U.S. mortgage mess is another major influence on interest rates. The first wave of defaults were subprime borrowers. The next wave will be adjustable rate mortgages with expiring teaser rates that are now adjusting up to market rates.

The third wave of defaults will occur if and when long term interest rates increase. Borrowers with

adjustable rate mortgages will be hard pressed to make their new higher payments.

These continuing defaults will force the government to reimburse investors for losses on government guaranteed loans. While Ginnie Mae loans are the only ones with an explicit government guarantee, the government takeover last weekend of Freddie Mac and Fannie Mae implies that those debts are government guaranteed as well. How will our government meet these new obligations? The choices are limited:

1. Borrow
2. Tax
3. Reschedule the debts
4. Sell off government assets (land, mineral rights, spectrum, etc.)

All of the above may be part of the solution, but most likely we will push this onto the next generation via massive government borrowing. This massive borrowing is sure to boost interest rates, unless the Federal Reserve decides to be the main buyer of all this new debt, in which case inflation will continue to soar. The scariest part is that as interest rates go up, it may further depress housing prices and also drive more adjustable rate borrowers into default. This could continue on as a self reinforcing housing bust.

So just to recap, the present situation of high inflation and low interest rates is the best situation for arresting the fall in housing prices. Unfortunately, this situation is unlikely to sustain. If rates go up or inflation goes down, it should put more pressure on the mortgage mess, which will increase the size of the government bailout, which will further raise rates.

With the specter of rising rates, our outlook for fixed income investing is negative. Fortunately, we are finding opportunities in equities which appear relatively attractive. The key is to identify industries which will be less affected by a severe economic downturn, such as Healthcare and Energy. We selectively invest in technology, but only where we feel the technology can grow despite economic headwinds. We also favor Real Estate Investment Trusts as a hedge against inflation, but we look for REIT's that can ride out a downturn through long term leases with creditworthy tenants. We have even found reasonable valuations in companies which benefit from recessions, such as pawnshop chains.

Robert Balopole, CFA

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