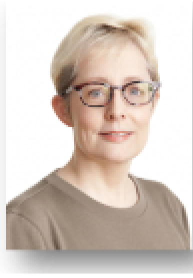
Forbes



Pamela Rosenau
VIEW FROM ABOVE

Dogmas of the Quiet Past – Why Higher Rates are on the Horizon

Feb 27 2018 – 03:48 pm

After nine years since the financial crisis, it may be of little surprise that we would experience (finally) some inflationary pressures in our economy. On several recent corporate earnings calls, I have heard an increasing number of management teams discuss how they currently face higher input costs, whether it be freight, packaging, labor, raw materials and/or energy costs. In most cases, the question is how quickly or to what extent these companies will pass along these increased costs to their customers. There are several examples of selected price increases being implemented -- even the wireless companies are ending their perennial discounted pricing strategies, which lead me to believe that these inflation pressures will continue. There has been much debate on what this portends for interest rates, which began to ascend higher approximately 18 months ago. There are now many signals that lead me to believe that even higher interest rates are on the horizon.

For starters, history tells us that the dynamics of the supply and demand for money are relevant for determining an appropriate level for interest rates. The Federal Reserve is decreasing the supply of money by tapering their balance sheet, while the demand for money will increase with the latest bout of expansionary fiscal policy (i.e. tax reform). Professor Lars Oxelheim of the Financial Times, recently wrote how historical precedence has shown how this supply/demand shift can lead to significantly higher interest rates over a short period of time. Of course, this would impact the valuation of all asset classes as discount rates head higher. Market strategist Dave Rosenberg recently added that “we have a government policy that is aimed at pushing fiscal deficits higher and pulling trade deficits lower. Say this over and over again – these two goals can only co-exist with rising interest rates.”

Also, who is going to stroll in on their white horse and be the new big US treasury bond buyer? We know that the Fed is pruning their bond portfolio. After all, newly installed Fed Chairman Powell showed his true colors six years ago when he warned of the “Greenspan put” and its implicit encouragement of risk taking. Considering his concerns back then, I cannot imagine him being overly dovish given the valuation excesses in our environment today. Furthermore, the Chinese could play monetary hardball as a response to any hostile U.S. trade actions and choose to mitigate their participation in our auctions, thus causing a sudden spike or pernicious reset in interest rates. Frankly, Xi Jinping has a license to do whatever he wants at this point.

A dearth of new buyers in conjunction with a hoard of new and unlikely bond sellers will lead to higher rates. Just look at one of the unintended consequences of tax reform. Some of the largest U.S. tech companies hold significant funds overseas, much of which is invested in bonds, not held directly in cash. If many of those companies decide to repatriate those funds to the U.S. as they are incentivized to do, their holdings (i.e. bonds) will have to be sold in a market with increasing supply. How high do interest rates need to be in order to accommodate that magnitude of new supply?

I believe the actions of the stock market maestro, Warren Buffet, may confirm this thinking as he has become a rather huge cash hoarder. Berkshire has become one of largest holders of U.S. treasury bills in the world, in fact they have considered this a sideline business -- a ‘dealer’ to the bond dealers. As discount rates move inevitably higher and asset classes reprice, he wants to have first-row seats to take advantage of the most favorable and attractive investment opportunities to come.

In the end, one thing is clear -- there has been a big paradigm shift in the financial markets. When equities recently corrected, bonds also sold off. Bonds did not provide the hedge that they normally do in a disinflationary environment – a cautionary signal of a new, less-benign inflationary period. Abe Lincoln once stated, "The dogmas of the quiet past, are inadequate to the stormy present. The occasion is piled high with difficulty, and we must rise -- with the occasion." In this market, it will pay to be opportunistic and tactical with portfolios over time as the market transitions to this new interest rate environment.

The Rosenau Group is a team of investment professionals registered with HighTower Securities, LLC, member FINRA, MSRB and SIPC & HighTower Advisors, LLC, a registered investment advisor with the SEC. All securities are offered through HighTower Securities, LLC and advisory services are offered through HighTower Advisors, LLC.

Pamela Rosenau, Managing Director and Chief Equity Market Strategist at HighTower and Chief Investment Officer at the Rosenau Group has over 30 years of experience in the financial industry. Ms. Rosenau was ranked #7 in Forbes' 2017 America's Top 200 Women Wealth Advisors, #67 in Barron's 2017 Top 100 Independent Advisors, #17 in Barron's 2017 Top 100 Women Financial Advisors and #39 in California for Barron's 2017 Top 1,200 Advisors list. Ms. Rosenau holds series 7, 63, and 65 licenses.

This document was created for informational purposes only; the opinions expressed are solely those of the author, and do not represent those of HighTower Advisors, LLC or any of its affiliates. In preparing these materials, we have relied upon and assumed without independent verifications, the accuracy and completeness of all information available from public and internal sources. HighTower shall not in any way be liable for claims and make no expressed or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in or omissions from them.

This is not an offer to buy or sell securities. No investment process is free of risk and there is no guarantee that the investment process described herein will be profitable. Investors may lose all of their investments. Past performance is not indicative of current or future performance and is not a guarantee. Carefully consider investment objectives, risk factors and charges and expenses before investing.