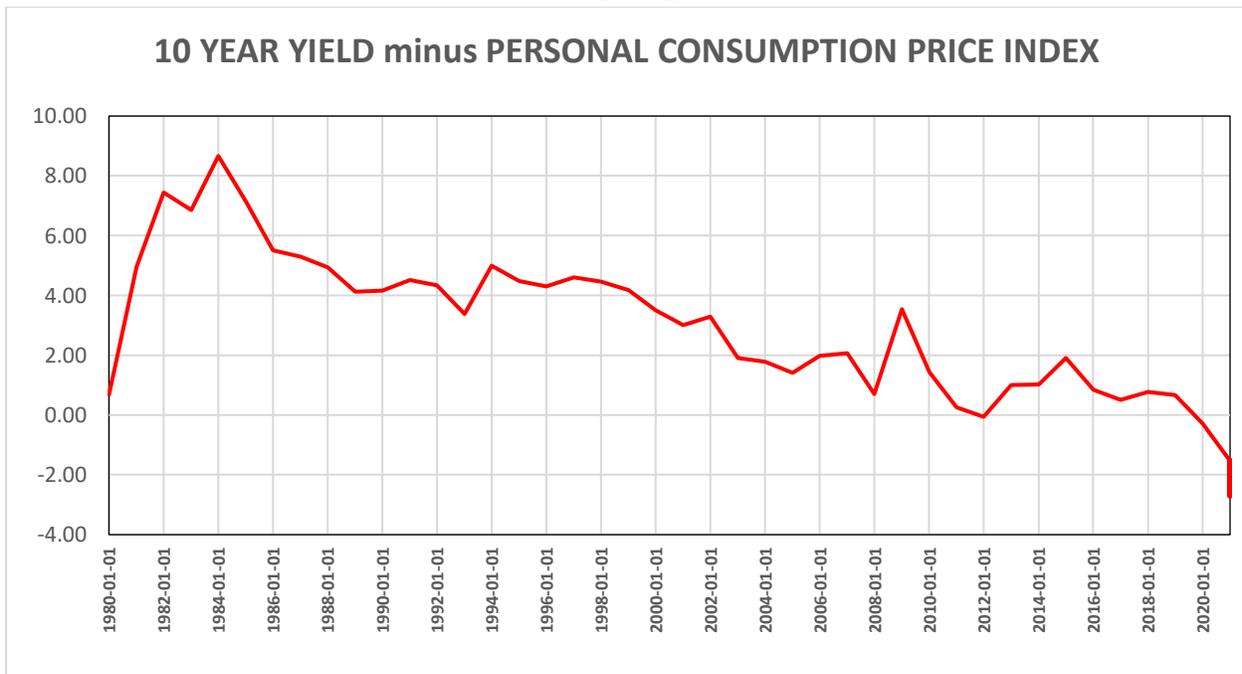


INTEREST RATES vs SHARE PRICES: A TALE OF TWO ECONOMIES.

While interest rates plumb new lows in real terms, share prices screech upwards. The first index speaks to a weakening economy, the second to an expanding economy. Both cannot be right.

When dealing with the rate of interest it is important to factor in inflation. Inflation can turn a positive **nominal** interest rate into a negative **real** interest rate. This can be seen in Graph 1 below. Additionally, when comparing international interest rates, it is the real interest rate that counts. For example the current negative yield on 10-year bonds in Germany is -0.22% and when we add in inflation that adds up to -2.6%. In Japan the inflation rate (if it is to be believed) is 0.2% and the 10-year yield is currently 0.0% resulting in a negative yield of -0.2%. In contrast, the US which is the only country to have a positive yield, if only at 1.2-3% ends up with a negative yield of -2.6% when inflation of 3.9% is factored in. This real -2.6% yield is close to Germany's real rate but far more punitive than Japan's. (If we were to use the current BEA deflator then the real US interest rate would be close to -5%.)

GRAPH 1.



(Sources: FRED Table PCEPI for prices and Table IRLTLT01USM156N for yields.)

We note that since the mid-1990s when globalisation proper kicked off, interest rates have been falling systemically in the USA as Graph 1 shows, and not only in the USA but in all the major economies bar China. To understand the rate of interest we must understand how demand and supply affects it and what in turn drives demand and supply. Our starting point is therefore the phasing of the industrial (business) cycle which is the primary determinant of demand and supply.

Marx pointed to 6 phases in the industrial cycle and all that differs between him and modern economists who also divine 6 phases, is the names Marx allocated to each phase and some of their characteristics (which we need not go into). He named them "*inactivity, growing animation, prosperity, overproduction, crash, stagnation*". (Chapter 22, Volume 3, Das Kapital) On the upside there is growing animation, prosperity, and overproduction. Crash is the turning point. Following it we have stagnation and inactivity

on the downside. The longest phase is prosperity and the shortest is overproduction. Strictly speaking the crash or financial emergency is not a phase but a high intensity event that lasts weeks rather than months. Stagnation would be called the recession proper these days.

Each phase is unique in terms of how it affects the demand and supply of loanable funds. The highest demand for credit occurs in the phase of overproduction and the lowest demand occurs during the phase of stagnation. Interest rates are therefore at their highest in the phase of overproduction and at their lowest in the phase of stagnation. This can be seen in the graph below during which time there were two recessions, 2001 and 2008. The use of Industrial and Commercial Loans are the best indicator of loanable demand because their terms tend to be under two years, and they are popular with smaller businesses. In both cases the issuance of loans increases into the recession only to fall after the recession, before reversing again as inactivity gives way to rising animation and then to prosperity.

Graph 2.

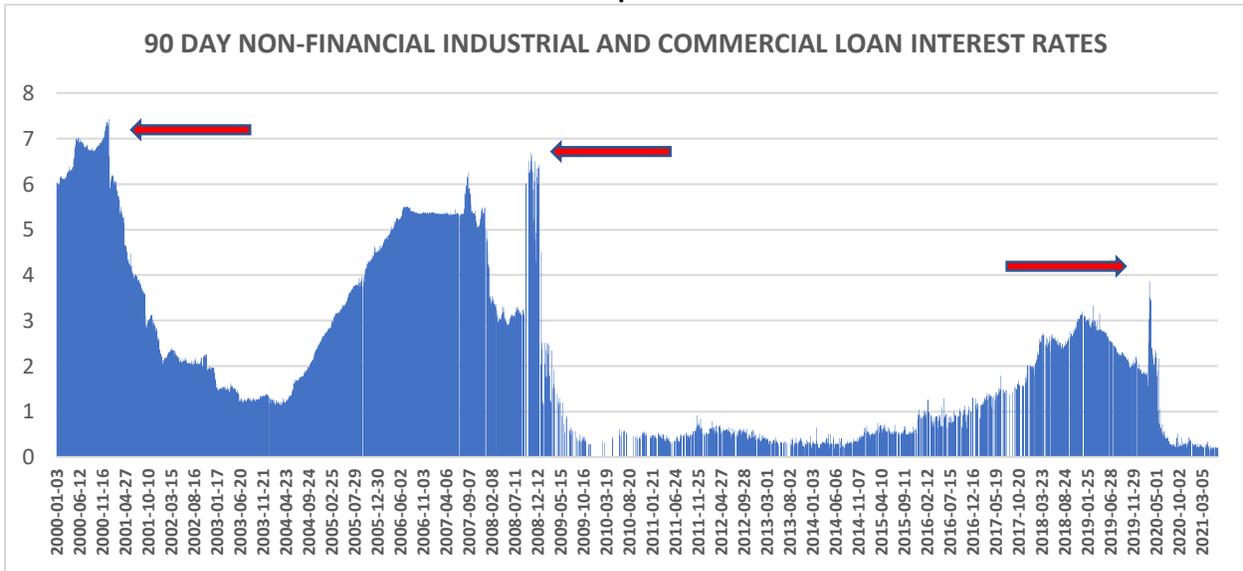


In the period of rising animation, though the rate of profit has now been restored and rising, every \$ or £ of investment requires a greater infusion of loan capital because internal cash flow is still limited. In the period of prosperity where the rate of profit is higher, internal cash flow provides a greater proportion of funds for investment. However, because the rate of investment is also higher, it contrasts out the higher contribution from internal funds so keeping demand for loans elevated. We leave out of consideration the phase of overproduction because here issues of circulation, rather than production, arise.

There is also an overriding consideration. The higher the rate of investment the greater the aggregate demand for credit money or loans. I have called this “innate debt”, and it is needed to cover the shortfall between legacy value understood as $c + v + s$ and current value which it circulates. Please view a recent article on this titled “*Innate Debt: why debt accumulates during the industrial cycle*”.

Changes in the volume of loans are normally associated with changes to interest rates. The undulating nature of loan generation tends to be matched by the undulating nature of interest rates as shown below.

Graph 3.

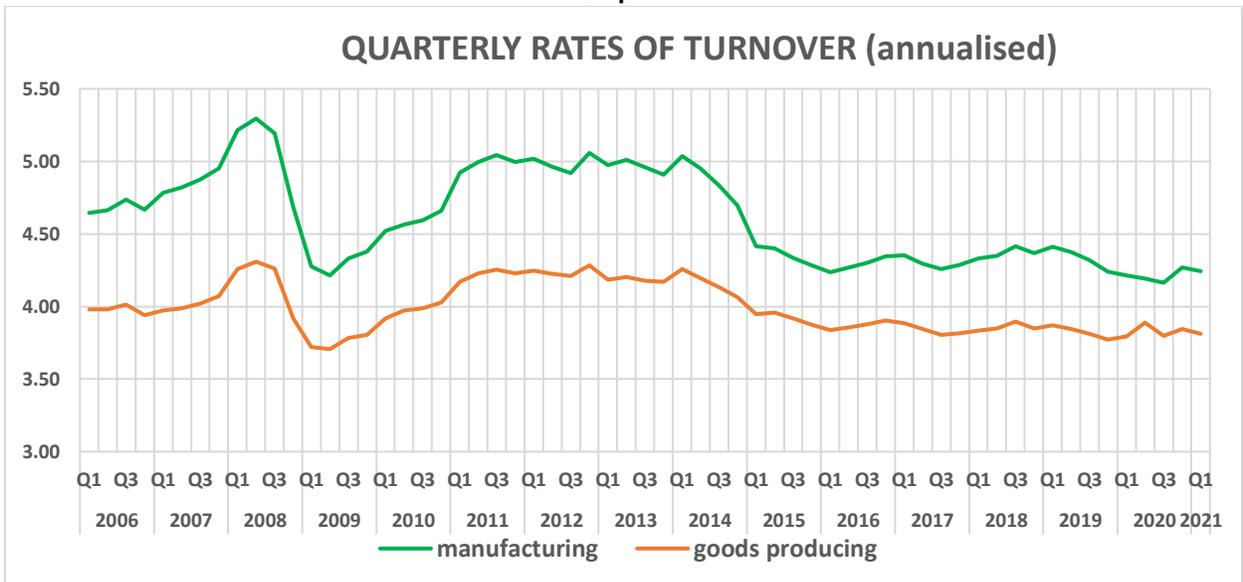


The fine detail in Graph 3 based on daily rates, shows 3 distinct and short-lived spikes. The peak just before or during the recessions in 2001 and 2008, and the third peak at the onset of lockdown. Thereafter interest rates fall precipitously on the downside before rising once again through the phases leading to prosperity.

Going back to Graph 1, we witness a longer-term fall in average interest rates. In the 20 years up to 2016 this was due to globalisation and the extended periods of prosperity this engendered. The transfer of value from countries like China helped shore up the rate of profit up to 2014 in the USA. During this period the largest global corporations enjoyed profits which exceeded their investment needs and thus one of the key components of demand was absent leading to subdued interest rates.

The rate of turnover.

Graph 4.



(Source: BEA Interactive Tables, GDP-by-industry Gross Output and Gross Value Added.)

I have added in the most recent rates of turnover. At the moment they are severely distorted by Covid Relief Funds, which appear as subsidies in company accounts, and which artificially elevate Gross Value Added thus acting as a drag on turnover according to the formula. However, there appears to be nothing in the sphere of circulation of capital to indicate pressures on interest rates currently. Turnovers continue to remain far below their 2008 and 2014 peaks even factoring in the effect of the relief funds. We will have to wait for the third quarter to determine actual turnover rates.

Discussion.

Two indexes or ratios, two perspectives for the US economy, one positive the other negative. Which one is right? This week two of the major three share markets, the S&P and Dow hit new highs driven by a “stellar” July jobs report. Even the 10-year yield pricked up its ears rising one basis point to touch 1.3% after the jobs report and rumours of early tapering.

The comforting jobs report which estimated 943K new jobs requires scrutiny. The Bureau of Labour Statistics data is always seasonally adjusted. This needs to be born in mind when contrasting it to the authoritative ADP’s survey which yielded only 330K new private jobs vs the 703K estimated by the BLS. Of the 943K new jobs, two thirds were in the leisure & entertainment sector plus teachers. Still sufficient progress to bump up the markets despite the current infection rate trending towards 200,000 (Fauci) and the possible replication of conditions in Delhi as hospitals start overflowing in some Southern States.

Understanding the trajectory of share prices is simpler than that of interest rates. FactSet’s current release covers 445 companies reporting earnings or 89% of the S&P 500 corporations. Collectively, earnings grew 88% compared to last year while revenue grew 25%. This yielded a margin of 13%, the highest since FactSet began collecting data. (Note 1.) More importantly the outlook for the next quarter remains positive with earnings growth of 28% and revenue growth of 14.4%. We shall see, but as long as Goldilocks appears to be beckoning through the windscreen, share prices will continue to be driven by investors who should know better.

Interest rates are more complex. First, we need to deal with the confounding factors. The three relief funds have injected \$1.05 trillion into the corporate sector. To put that in context, this is equal to over 70% of annual post-tax profit for the sector. It is also equal to 70% of the annual net issuance of corporate bonds, or 100% when set against bonds issued solely by the non-financial sector. [U.S. Corporate Debt Market The State Of Play In 2019 | S&P Global \(spglobal.com\)](#)

This infusion of funds has allowed many corporations, especially those on the edge, to recapitalise themselves. The last time this occurred was in World War 2 when the overpricing of government contracts infused new capital into business allowing them to expand production especially military. Currently there is another infusion, this time via the impulse of demand. The relief funds have fuelled consumer spending, and this has fuelled a rise in prices which in turn has elevated profit margins by between 2 and 3% or an extra \$300 million in post-tax profits.

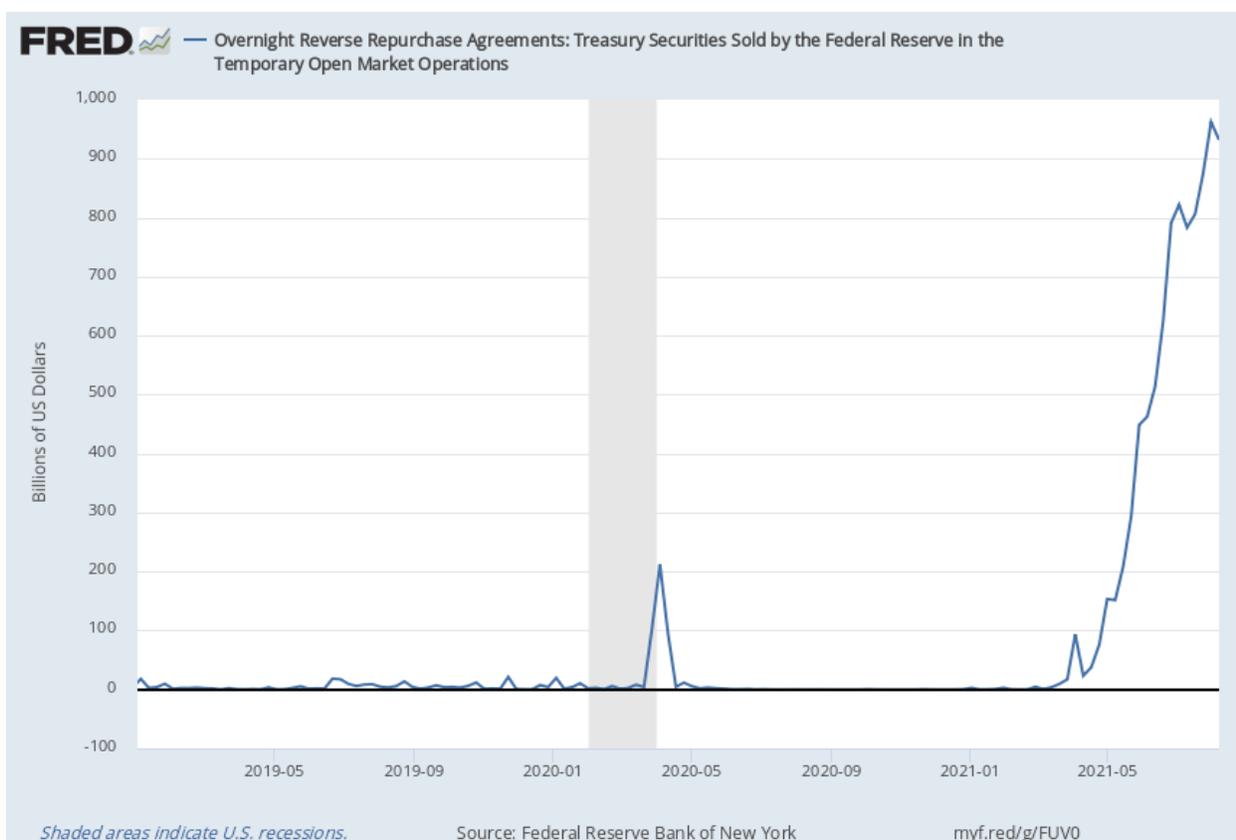
Thus much of the funds needed to generate investment, even increased investment, can currently be financed by internal funds. The result is subdued demand for credit, despite record issuance of corporate bonds in 2020 which was used mainly to refinance existing debt. Accordingly, there is hardly any upward pull on interest rates arising from the demand side.

In fact what little demand there is, has been overwhelmed by the over-supply of funds. So much so that the large commercial banks have been turning away deposits from their corporate customers because their vaults are full. *“Usually, deposit growth is a welcome indicator of a healthy economy and allows banks to lend more. But, in the absence of comparable loan demand, extra deposits can be costly for banks, requiring them to hold more capital.”* <https://www.afr.com/companies/financial-services/cash-rich-us-banks-move-to-reduce-corporate-deposits-20210504-p57otn>

The economy is awash with liquidity. The FED has pumped so much money into the economy that it has not only filled the bath, but the bath is overflowing and flooding apartments downstairs and flushing any monetary discipline down the toilet. As a result the FED has had to deploy a giant sponge to try and mop up all this liquidity. It is called - reverse repo. Banks and investors are holding so much cash, which is earning nothing, that they are willing to shovel it back at the FED to earn a measly 0.05%. So overnight an amount as large as \$100 billion will earn around \$1,400 in interest. Dammit you cannot even buy a Rolex for that.

This financial nonsense can be seen in the graph below. It shows how the weekly amount of reverse repos currently reaches almost \$1 trillion. What the FED God giveth with one hand, s/he taketh back with the other, with the taxpayer adding a tiny stipend.

Graph 5.



Given QE and fiscal largesse, the demand and supply of loanable funds has been largely disrupted. Interest rates have lost most of their regulatory function. Despite this, given the background of rising inflation, (which is likely to peak in August, but remain elevated for the next six months) the behaviour of interest

rates is still abnormal. The fact that short term interest rates did not respond to inflation reports which surprised on the upside while responding to employment data which also surprised on the upside, would tend to suggest they are still indicating economic disruption ahead.

Pockets of economic weakness are already appearing around the world but the data is still patchy. We will know more by the end of August or early September.

Note 1. Michael Roberts provided me with a report from Goldman Sachs which looked at the cost price side of margins during the pandemic. Goldman reported that substantial savings resulting from home working and no doubt using machine learning to reduce hours, had reduced costs and elevated margins. However, this report did not factor in the rise in margins on the demand side from price increases nor directly from subsidies. In the absence of these factors it is impossible to determine how much of the improvement in margins was due to cost reductions.

Brian Green, 7th August 2021.