BUSINESS

Road to Retirement: How inflation could destroy markets, or not

By **CHARLIE FARRELL** | cfarrell@northstarinvest.com | Special to The Denver Post

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With President Joe Biden's administration looking to pass another $2 trillion stimulus plan, and with some in government prepping the markets for another stimulus bill later this year (infrastructure), investors are starting to worry that this may all be too much. The reality is the overall economy has recovered. Household incomes are up, the stock market is up, housing is up, and GDP has recovered. Yet Congress continues to pour more stimulus into the economy.

What's wrong with giving everyone more money? The concern from investors is that excessive stimulus will ignite inflation well above the 1.5% rate investors have gotten comfortable with over the last 15 years. The reason sharply higher inflation worries investors is because historically when inflation went up, so did interest rates. For instance, if inflation was 4%, interest rates might have been 6%.

As interest rates rise, the economy slows because it becomes harder to borrow money and pay it back. A slower economy means less consumer spending and lower profits for companies, and thus the stock market usually declines in value. That's the way it used to work anyway.

Photograph by Ellen Jaskol
Charlie Farrell

But does the relationship between higher inflation, higher interest rates, and a slower economy still hold true in a world of manipulated markets? It may not, and here's why. The real issue is not higher interest rates, it's whether interest rates are higher than the inflation rate. If interest rates stay below the rate of inflation, then the economy may eventually self-adjust.

Here is a simple example of how this can work. Let's say you have household income of $100,000, an interest only mortgage on your house at a 3% interest rate, and your mortgage balance is $333,000. That means you will owe about $10,000 a year in interest payments ($333,000 x 3%). Let's also assume the interest rate adjusts each year.

Now if inflation goes to 4%, we'll assume your household income goes up to $104,000 because you got a cost-of-living increase. But interest rates jumped to 6% because they tend to be a few percentage points higher than inflation.

With a $333,000 mortgage balance at 6%, now you owe about $20,000 in interest each year, or $10,000 more. But your income only went up $4,000. You will have to cut back on spending in other areas to net the additional $6,000 needed on your line of credit payments. Multiply this effect across millions of households as interest rates go up faster than incomes, and everything starts to slow down. That's why an inflation spike is dangerous.

But what if interest rates stay below inflation? Then we are looking at a more manageable situation. Here is an example. Again, assume that inflation is 4%, and your income goes up to $104,000. But interest rates only go up to 3.5%. In this case, your interest costs would rise to about $11,700 a year ($333,000 x 3.5%), or $1,700 more. But your income went up $4,000, so you have extra money to cover these interest costs. This is how things self-adjust. The key is the interest rate must stay below the inflation rate.

The big question for investors is if inflation spikes, will interest rates exceed inflation? If so, it will get ugly. There is no easy way to assess whether the Federal Reserve and Treasury can control rates if inflation spikes. It will be a battle between investors vs. the Feds. Investors will try to drive rates up to compensate them for the inflation risk and the Feds will try to drive rates down. It's really a question of who can bring more firepower to the markets.

In terms of access to money, the Feds believe they have unlimited capital to push markets in the direction they want. Today, that is probably the case. Our sense is that ultimately the Fed and Treasury will do everything they can to keep interest rates low. If that means spending $5, $10 or even $15 trillion to repress interest rates, they'll probably do it.

As with all things in finance, there are no guarantees. Only in hindsight will the answer be obvious. I'd put the odds at 50% to 60% that the Fed can keep rates below inflation for the foreseeable future. Markets, however, could experience periods of severe volatility as investors battle with the Fed over who will control rates.

If investors win and permanently drive-up interest rates, expect a tough slog for stocks. If the Fed wins and manages to keep rates low, expect the stock market party to continue.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.