



## **Interest Rates Are Going Up**

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Interest rates have finally begun their long anticipated and widely dreaded increase. Over the last thirty days the bellwether ten-year Treasury note has increased from 3.35 percent to about 4 percent today. As a result, mortgage rates, which are priced off the ten-year note, have increased as well, with thirty-year mortgages now at 5.61 percent, compared to 5.11 percent last month.

Interestingly, at the short end of the yield curve there is no movement yet. The federal reserve has maintained the funds rate at an extraordinarily low level of 1 percent, and this has kept the prime down to 4 percent – even as other, longer term rates have increased. However, it is only a matter of time until the fed will raise the funds rate and banks will increase prime as well.

Clearly, the pressures are building fast. The U.S. economy is estimated to have grown by at least 4 percent to as much as 5 percent during the first quarter, and the economic momentum appears to be building based upon the monthly data releases. Employment was way up in March and the weekly readings on new claims for unemployment compensation point to further gains in April as well. Industrial production is rising at a good clip, reflecting the rebounding manufacturing sector.

More ominously, commodity prices have escalated sharply. Obviously, oil prices are the most notable. But they are hardly the only commodity whose price has increased dramatically. For example, gold is trading over \$400 per ounce, and base metals prices are up over 25 percent compared to last year. More generally, the Producers Price Index for crude goods, has increased a whopping 24 percent compared to last year. Fortunately, most manufacturers have some excess capacity, so they are not fully passing along these increases in crude goods prices into the prices for finished goods – at least not just yet. However, this cannot continue much longer. Finally, the federal budget deficit isn't going away any time soon.

So with these various forces in place, interest rates will keep on rising for the rest of this year and in 2005 as well. The issue in the near term is how quickly the fed will react. If the fed moves decisively in the next ninety days by raising the fund rate, we will avoid any inflationary problems, and the spread between the longer term rates, like the notes and the mortgages, will shrink as short term rates rise towards the longer term rates. However, if the fed dillydallies there is a real risk that long-term investors will lose some confidence and begin requiring some premium to induce them to invest longer term. If this develops, then long term rates will continue to lead the market higher, and everyone will suffer.

This is Hank Fishkind for 90.7 FM, WMFE News.

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