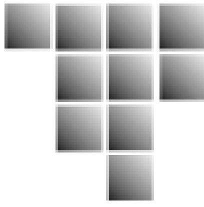
FISHKIND
& ASSOCIATES



Rates Go Up Across the Globe

May 26, 2004

Interest rates are rising not only in the U.S. but also across markets around the world. This is due in part to market forces and in part to a global tightening of monetary policy.

In terms of market forces, the global recovery is picking up steam. Lead by the booming Chinese and U.S. economies, global demand surged in the first quarter, and the momentum is building. At current rates expanding global demand will quickly use up existing idle capacity and trigger an investment boom. Rising aggregate demand coupled with higher levels of investment will put pressure on national savings world wide, and this in turn will put pressure on interest rates. Furthermore, commodity prices are also rising rapidly, and this increases the pressure on global inflation as well.

http://www.fishkind.com

Responding to these improving market conditions, central banks have begun the long and painful process of tightening monetary policy. Actually, central bankers are merely restoring neutrality to monetary policy after a lengthy period of monetary stimulus. Australia and the UK were the first to raise interest rates, and the U.S. fed is soon to follow suit. This marks the end to the global cycle of easy money policies, and by year end all central banks will be tightening liquidity and raising their target rates for policy instruments, which in the U.S. is the federal funds rate.

So this combination of stronger economic growth, rising commodity prices, and more restrictive monetary policy will combine to push short-term interest rates up substantially across the globe. This will place additional pressure on U.S. rates, since U.S. borrowers will not be able to tap global markets for lower rate funds. My forecast envisions the fed raising the funds rate in quarter percent steps starting at its next meeting in June, and by half percent steps after the election. This will bring the funds rate up to 3.5 percent by year end. The ten-year treasury will continue to increase from its current trading range of about 4.75

percent to 5.5 percent by year end. Since mortgage rates are priced off the ten-year, they will rise to 6.75 percent by year end.

In this environment the U.S. economy will be affected in a variety of predicable ways. Housing starts will slow and car sales will peak out. The dollar will strengthen, which in turn will damp demand for U.S. exports. But at these levels of interest rates the damage will be modest. The stock market has already anticipated these conditions; in fact some would correctly argue that it has over compensated. Rising rates do not help stocks. However, it is easy to over emphasize this truism.

Reviewing previous episodes of monetary tightening in 1977-78, 1981-82, 1986-88, 1994-95, and 1999-2000 reveals that stock prices are only down on average a small amount over the tightening cycle. So hunker down and ride out the storm.

This is Hank Fishkind for 90.7 FM, WMFE News.

http://www.fishkind.com