ChartsandMarkets.com

Timely technical analysis
Insightful market commentary

BOB HOYE

JANUARY 15, 2019

Real Long-Dated Interest Rates: A Disaster In Waiting

One of the features of great financial bubbles has been that real long-dated interest rates [1] go down. It is part of the party. But in the inevitable contraction they go up. Hugely. On the five great examples the typical increase has been 12 (no typo) percentage points.

These have been the most severe financial calamities in a generation and they have been Mother Nature's way of correcting the abuse of credit, otherwise known as a "New Financial Era" – the times when recklessness becomes risk free. The 1929 example was number five. The 2000 Dot-Com Bubble was unique and the 2007 Bubble was not quite a classic example. However, the bubble that completed in 2018 had many of the features, which we reviewed during the year.

The key has been that each example completed some 9 years after a huge mania in commodities blew out. Then, discouraged as tangible assets crashed, the public turned to financial assets. Recent examples were commodities in 1864 and stocks in 1873. Then the key years were commodities 1920 and 1929. We reviewed this in August 2017. The peak in 2008 was outstanding with crude oil soaring to 147. A monthly commodity index is available for 1920 and the span was 9 years and 5 months. The latest ran for 9 years and 7 months.

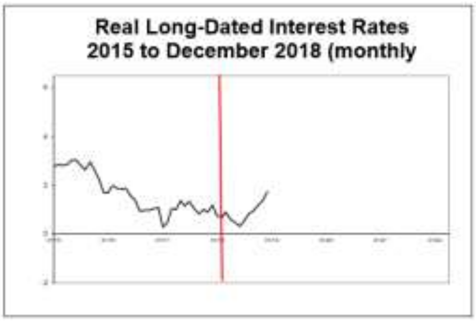
In a boom. short-dated rates of interest increase, which pattern existed well before the start of central banking. And in business contractions such rates go down. It's the opposite for long real rates. The boom increases the rate of CPI inflation as "reaching for yield" drives nominal long rates down. Every time. In three out five examples, it declined to minus territory. Charts follow.

One of the most fascinating things in financial history has been the transition from speculation in commodities to speculation in financial assets. In London in the last half of the 1600s, there were enough public companies to call it a stock market. The first financial letter began publication in 1692. The modern world of finance began with intrusive central banking in 1694. And the first bubble was invented in 1719, completed in June 1720 and crashed in the fall of that fateful year. All five, including the 2018 example were similar on the way up and suffered forced liquidation in the fourth quarter.

The next fascinating financial event has been the transition from speculation in paper to the hoarding of cash. The public creates the transition and it has little to do with central bank policy. The avoidance of risk drives rates for lower-grade securities up as the price of most things deflate. This, of course, forces long rates up as the rate of CPI inflation goes down.

The following chart shows that with our bubble the rate declined to somewhat below 1 percent into June. The rise since is part of the pattern identifying a post-bubble contraction. The potential is for a dislocating rise in real long-dated interest rates.

[1] The nominal rate of interest adjusted by the rate of CPI inflation.



The following charts show the action through all five prior bubbles. Other key features (not shown) include declining real prices for base metals and a rising trend for gold's real price. The former have been declining since last January and gold's real price has yet to set an uptrend. Of course, there is no guarantee that the pattern will continue to work out. But as there is no guarantee that it won't, it is prudent to consider the odds.