The Fed Is Irrelevant: Low Interest Rates Are the New Normal

It’s time to consider a new paradigm for interest rates – a paradigm where treasury rates remain ultra low and riskier investments are priced by a decentralized market instead of a central bank.

For years, we have been warned that interest rates will inevitably rise from their “artificially” low levels back to the “normal” levels of the early 2000’s.

In the mainstream narrative, the Fed has been artificially holding interest rates down to stimulate the economy, and soon it will have to raise rates to more normal levels. If it fails to do so, pundits warn, the economy could suffer dire consequences.

There are three problems with this narrative:

1. Today’s low rates represent the long-run natural cost of capital.
2. Perpetually low interest rates can have positive effects on the economy.
3. The Fed doesn’t control interest rates, the market does.

Lower Rates Fit Long-Term Trend

Most analysts predicting a return to higher interest rates cite the past several decades as evidence that a higher cost of capital is the norm. Figure 1 shows the long-term trend in interest rates suggests otherwise. If we treat the massive spike in the late 20th century as an aberration, today’s low interest rates look like the continuation of a 200+ year trend.

![Figure 1: Long-Term Decline In Interest Rates](image)

It’s not just the Fed that’s been holding rates down for the past several years. It’s been structural shifts to the economy such as low inflation expectations, an aging population (more savers, fewer workers), increasing economic stability, and a variety of other factors recently detailed in the Wall Street Journal.
Not all fixed income securities will have low rates. We are saying that the floor on rates should remain low, and that the Fed would be well advised to recognize this shift as a new paradigm.

**Politics Put A Ceiling On Rates**

As low as our rates are now, they are still higher than most of the developed world, e.g. Japan and Europe. There are no signs that either of those central banks plans to raise rates in the foreseeable future. As a result, higher rates in the U.S. would further strengthen the dollar, put more strain on forex markets and undermine foreign revenues to our international companies.

In addition, think of the strain put on the U.S. government's budget from a rise in treasury rates. Debt service costs could quickly become troublesome for our government if the Fed pushed rates back anywhere close to the old "normal".

**The Threat of Higher Rates Is Hurting Investment and Long-Term Growth Potential**

The primary challenge facing our economy is that moderate-to-low ROIC opportunities are going unfunded despite an abundance of uninvested capital. The 2,183 Russell 3000 companies for which we have at least 5 years worth of data hold nearly $1.6 trillion in excess cash, up 43% from five years ago. Meanwhile, their invested capital is up just 25% over the same time period.

Companies have money on hand to invest in their operations, but they’re mostly choosing to hold that cash on the balance sheet or buyback stock. Many of these companies are holding back from making investments that would earn an ROIC in the low-to-mid single digits. These are investments that could generate positive economic earnings with today’s low interest rates but would look much less appealing if rates rose in the next few years.

Economists from Duke and the London School of Economics have shown that interest rate uncertainty significantly depresses the level of investment both on an individual firm level and throughout the economy. By constantly talking about raising short-term rates without setting a clear timeline, the Fed has created a great deal of uncertainty that is undermining growth.

If the Fed were to remove this uncertainty by announcing that it wouldn’t raise rates any time in the foreseeable future, companies would be more inclined to start investing in these moderate-to-low ROIC opportunities.

Homebuilding is a good example. The overall housing market may be recovering, but new housing starts remain persistently low. The 16 homebuilders we cover have a weighted average ROIC of 6%, putting them right on the bubble of economic profitability.

A signal that rates will stay low should encourage homebuilders to increase their level of investment. This would not only increase the country’s strained housing supply, it would also create jobs that might bring some of the 6 million people who want a job but aren’t actively looking for one back into the labor force.

**The Threat of Higher Rates Is Hurting Employment**

Workers trained for the old economy find their skills devalued, resulting in underemployment, unemployment, or an exit from the workforce.

Ideally, we want to retrain these workers to with the skills needed to find jobs in the high ROIC industries that are facing labor shortages. That level of training might not be feasible, so many of these discouraged workers are forced to the sidelines.

If the Fed tries to raise rates, business investing will fall even further, leaving more workers unemployed. Workers on the sidelines are a waste of human capital and turn into drains on society through things like unemployment benefits.
How the Fed Lost Control Over Interest Rates And Free Markets Took Over

As the dissemination of capital has been decentralized, so too has its pricing. Private equity firms, credit card lenders, and business development corporations all set their own rates based on their assessment of risk/reward.

Keep in mind; the Fed has never really directly controlled interest rates. Rather, it uses open market activity to influence the Federal Funds Rate, which is the rate banks charge each other to borrow reserves overnight. This practice could affect short-term interest rates when banks had a virtual monopoly on fixed income capital dissemination, but today's more decentralized market makes it harder for the Fed to exert such direct control.

Why We Do Not Need Centralized Interest Rate Controls

As we establish in our report “How The Internet Economy Killed Inflation”, the inflation spikes that warranted higher interest rates are probably a thing of the past. In addition, there are a number of other technological and structural shifts in our economy that support a permanently lower cost of capital.

The past few decades have also seen a significant decentralization in the allocation of capital. Once upon a time, most capital was disseminated through the banking system. When loan officers were the primary distributors of fixed income capital, society needed to put a floor on interest rates to help ensure these officers allocated capital to investments that would earn a minimum level of return. Loan officers had no incentive to take risk most of the time, nor did they have much, if any, skin in the game.

In contrast, today, we have thousands of non-bank financial institutions—from credit card companies to peer-to-peer lenders – to provide capital to businesses and individuals. Crowd-sourced funding has launched major companies like Oculus Rift, and websites like Angel List make it easier for startups all over the country to find VC investors. These agents have skin in the game and require no outside incentive to seek higher returns and optimize their risk/reward.

Markets Are Better Than The Fed At Setting Rates

No matter how smart the Fed’s Governors are, they can’t compete with the wisdom of the crowd. A large group of independent individuals tends to be more accurate than a small group of experts.

In the past, this small group of experts may have been the only ones with enough information to judge the true state of the economy. That’s no longer true. Every individual has mountains of data at their fingertips. While not everyone can be right, on average the millions of individuals making capital allocation decisions based on this wealth of information will come to an aggregate picture of the economy that is as accurate, or more accurate, than that of the Fed.

Capital Flows To High Return Opportunities More Naturally Than Ever

In the old, centralized model, bankers had more incentive to minimize risk (and keep their jobs) rather than maximize returns. It’s the classic “No one ever got fired for buying IBM” scenario. When older investors talk about their greatest mistakes, it’s inevitably the bad investments they made.

Today, the opposite is true. Ask any of the high profile venture capitalists out there about their biggest mistakes, and they’ll talk about the wildly successful startups they passed on. With more and more people becoming the agents of their own capital and seeking to maximize their gains, capital flows to high return opportunities more naturally than ever.

When we wrote “How Artificially Low Interest Rates Harm Economies in the Long Term” and argued against low interest rates because they allowed suboptimal ideas to get funded, we were thinking in the old, centralized paradigm. Since then, it has become increasingly clear that the investment opportunity schedule has shifted. The top tier of companies that can earn extraordinarily high returns on invested capital (ROIC) create a larger and larger share of the value in our economy. Figure 2 shows that companies with ROICs in the top decile have earned an ever larger share of the total after-tax profit (NOPAT) generated by Russell 3000 companies over the past five years.

As the billions of dollars of capital flowing to VC firms shows, the next Google or Apple will have no trouble getting the funding it needs. In our dynamic, modern economy, the equity model ensures that the best
innovations, the ones that create significant a disproportionate amount of the jobs and value, will have the necessary amount of capital allocated to them.

**Figure 2: Share Of Profits Earned By The Top 10% For ROIC In Russell 3000**

We live in more of a winner-take-all business environment than ever. The winners may be knocked off and replaced at any time by a new firm, but the speed at which technology allows us to implement and disseminate new ideas makes market share gains much easier to achieve quickly.

The more people that we can empower to create new ideas and new technologies the better. We have a better chance of making that happen if the Fed removes interest rate uncertainty.

**How Should The Fed Act In The New Economy**

Instead of hitting the brakes on an already slow growing economy, the Fed should accept what the market is saying about interest rates. A strong signal from the Fed that it won’t raise the Federal Funds Rate for the foreseeable future would stimulate the economy, potentially bring millions of people back into the labor force, and create a more productive society.

Common wisdom says “Don’t Fight The Fed.” Today, the opposite is true. Janet Yellen and other members of the Board of Governors may want to raise rates, but the narrow yield curve shows markets continue to push rates down. As it turns out, the Fed is reluctant to fight the market.

And, most important for long-term economic growth, informing the world that low rates are here to stay would force congress and the White House to make the long overdue fiscal policy reforms that we need to get our economy going again. The Fed has been pushing with a string for a long time. The markets have made that clear. It is time for us to do the hard work that can and will drive real change, and that work is in fiscal policy not monetary policy.

*This article originally published [here](#) on September 26, 2016.*

**Disclosure:** David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

*Scottrade clients get a Free Gold Membership ($588/yr value). Login or open your Scottrade account & find us under Quotes & Research/Investor Tools.*
**New Constructs® – Profile**

**How New Constructs Creates Value for Clients**

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock’s valuation. We do the diligence on earnings quality and valuation so you don’t have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn’t fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don’t judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating ([details here](#)) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

**Our Philosophy About Research**

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

**Additional Information**

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.
DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, “New Constructs”) is an independent organization with no management ties to the companies it covers. None of the members of New Constructs’ management team or the management team of any New Constructs’ affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs’ Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs’ reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.