

Episode 12

Inflation vs interest rates: the great debate

Kara O'Halloran ([00:05](#)):

Welcome back to FireSide a podcast from FS Investments. My name is Kara O'Halloran. I'm a director on our Investment Research team here, and I am once again, joined by Lara Rhame. Our Chief U.S. Economist, Lara. Welcome.

Lara Rhame ([00:17](#)):

Hey, thank you. This is going to be a good one.

Kara O'Halloran ([00:19](#)):

I think so, too. It's a hot topic. So we are back again to talk about inflation and more importantly, the big question out there, which is why inflation is rising and bond yields are falling. So we did an entire episode on inflation a few months ago, and we said that that would not be the last time that we were talking about inflation in 2021. And we were spot on because here we are. And on that episode, which keep in mind, we recorded before both the May and June CPI readings. We talked about how we did expect inflation to rise largely due to base effects as prices had really plummeted last year.

Kara O'Halloran ([00:55](#)):

But we also talked about some of the supply constraints and pent-up demand that could cause pricing pressures. And now lo and behold, here we are. We had a CPI reading in both May and June north of 5%, which were the largest increases in over a decade. But another thing Lara, that you said then is ignore, ignore, ignore.

Lara Rhame ([01:15](#)):

Um, yeah.

Kara O'Halloran ([01:15](#)):

And we've seen that happen. At least I should say markets have not really reacted. We as investors are certainly paying close attention to inflation. Actually, I think the market reaction has been a little bit surprising because as I said, interest rates are declining.

Lara Rhame ([01:31](#)):

Yep.

Kara O'Halloran ([01:32](#)):

The yield on the 10 Year Treasury has fallen in recent weeks. At one point dipping below 120 basis points. So Lara, the million-dollar question is, why are bond yields falling while inflation is rising?

Lara Rhame ([01:45](#)):

All right,

Kara O'Halloran ([01:46](#)):

Long-winded there.

Lara Rhame ([01:47](#)):

Let's tackle this right off the top. It's important to really, I think on the interest rate side, realize that, historically we've had a more clear-cut driver of interest rates. And one of the big pieces of that is inflation. A lot of us remember maybe not you Kara, but me, my parents, a lot of the Baby Boomer generation,

Kara O'Halloran ([02:15](#)):

I've read about it.

Lara Rhame ([02:15](#)):

Yeah. Remember the inflationary period of the 70s and 80s and interest rates certainly were rising in lockstep with those higher inflation rates. So, inflation is absolutely a part of the broad interest rate narrative, but the driver of interest rates right now has really changed. We've seen structurally outside of inflationary trends over the past several decades, we've seen interest rates fall. That's been something we've all been experiencing as investors, as home buyers. We've all seen interest rates on this multi-decade decline.

Lara Rhame ([02:58](#)):

And it's left us with global yields that are in many cases, negative especially for developed markets. That really puts pressure on U.S. interest rates to fall. And then of course the pandemic. Really and this started in the Global Financial Crisis. We've seen fed policy pivoting to explicitly pushing down long-term interest rates as a way to help support the economy. So, right now I think it's wrong to say that markets are totally ignoring inflation. It's just that all of these other factors are really overwhelming any concern about inflation because policy, structurally, and globally we are experiencing low-interest rates.

Kara O'Halloran ([03:45](#)):

So our markets, right. Should we ignore inflation? How closely should we be paying attention?

Lara Rhame ([03:51](#)):

Yeah. I mean, I think this is really where the rubber meets the road because while markets... And I think, we say ignoring it, we look at long-run market interest rates,

right? Like the 10 year yield. Exactly, as you said. Today, I just checked walking in here. 1.24 is the long-term of the 10-year yield. And you look at sort of the market rates that reflect inflation expectations. And I looked at the ten-year break, even it's at 2.25 Right around, but consumers are not ignoring inflation. Investors are not ignoring inflation. Companies we're coming off of, we're still in the middle of an earning season where inflation is one of the most mentioned buzzwords of earnings calls. So, when we look at, we actually have really good surveys of consumer inflation measures and what households are expecting.

Lara Rhame ([04:51](#)):

And in the next year, households are expecting CPI to remain around where it is, around 5%. Over the next five years, households are expecting inflation to be around 3%. Those numbers show that while markets may be throwing the dart out into the future and hitting at much lower than sort of this 2% number that everybody always naturally coalesces around when we think of inflation and what's the right level of inflation, a lot of other stakeholders are not being so sanguine. And I think that's really a question.

Lara Rhame ([05:31](#)):

So, but that's not what you asked me. Right? You asked me, are they right? And I think that is something that I am perhaps more concerned about. We're seeing this is where we have to remind people inflation isn't just a CPI print, right? Inflation is wage inflation. It's household wage expectations. It's this cycle of companies facing higher input costs, right? We have commodity price inflation. It's all of those cycles that then cause companies to raise their prices and cause households to see higher prices coming at them and demand higher wages. Right? This whole ecosystem is really what we're thinking about when we think about inflation. It's much more than just one number. And right now all signs are pointing to inflation rising for the next several quarters.

Kara O'Halloran ([06:29](#)):

So this brings up another question that I have. I think if unprecedented was the word of 2020, I'm going to coin transitory as the word of 2021.

Lara Rhame ([06:38](#)):

Yeah.

Kara O'Halloran ([06:39](#)):

We have heard it at Nauseum, but what does transitory mean? I mean, you just said we could see prices increasing for the next several quarters. I don't understand what transitory is.

Lara Rhame ([06:49](#)):

Right.

Kara O'Halloran ([06:50](#)):

It can mean something different to everybody.

Lara Rhame ([06:52](#)):

And I think that is a big misunderstanding right now. And it's one that as market analysts we've created. When we had our podcast before, which really correctly, foresaw this really big rise in prices, that was really because of base effects due to the pandemic, right. That really took place in March, April, and May. Here we are in June. Those sorts of technical base effects should have passed by now, but we're seeing a whole other parts of price pressure coming from food from used cars, from input costs. And people say, this is all going to be transitory, but transitory could be the next four to six quarters. We could be talking about inflation running much higher than we're used to well into 2022. So from the market's viewpoint from the fed's viewpoint, they're thinking in such a long-term horizon. But as investors, as households, we could really be in for quarters of inflation that continues to bubble up from a lot of different places in our economy.

Kara O'Halloran ([08:01](#)):

Well, and especially since there are, as you said, those different sources, this is probably a terrible analogy. But I think about it almost like my credit card statement. Because, I convince myself every time I'm like, oh, it's high because I just had that one big thing I had to buy-

Lara Rhame ([08:14](#)):

Right.

Kara O'Halloran ([08:14](#)):

During that month, but it seems as though every single month I find some big purchase that I just must make. And that's why I perpetually have a high credit card.

Lara Rhame ([08:22](#)):

Yeah.

Kara O'Halloran ([08:22](#)):

I pay it every month. Don't worry, but it's kind of like inflation. Its we could see just those one-off things. Keep that inflation number higher.

Lara Rhame ([08:32](#)):

That's exactly right. I mean, I think something that we often notice just as people who live in the economy that, the CPI numbers will look really low, maybe not right now, but in years past. And we're like, wow. And yet the concert tickets and my cable costs and a lot of day-to-day things. My grocery basket feels like it's rising a heck of a lot faster than, sort of some 2% number. And right now I think we're really feeling that. I mean, we have to buy a car, Kara.

Kara O'Halloran ([09:06](#)):

Oh no.

Lara Rhame ([09:06](#)):

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So just to let you into my little-

Kara O'Halloran ([09:08](#)):

Oh no.

Lara Rhame ([09:08](#)):

Piece of the inflation picture.

Kara O'Halloran ([09:09](#)):

God speed. Well, I think I sent you, prices are rising faster than stores can reprint signs. I think-

Lara Rhame ([09:15](#)):

Yes.

Kara O'Halloran ([09:15](#)):

I sent you a photo from a-

Lara Rhame ([09:17](#)):

Yeah.

Kara O'Halloran ([09:17](#)):

Starbucks a couple of weeks ago where they had literally crossed off the prices and added higher or-

Lara Rhame ([09:22](#)):

It's true.

Kara O'Halloran ([09:22](#)):

Handwritten in higher prices.

Lara Rhame ([09:23](#)):

Yep.

Kara O'Halloran ([09:23](#)):

We got a good laugh about that. So, all right. I want to bring this back to the interest rates conversation.

Lara Rhame ([09:31](#)):

Yeah.

Kara O'Halloran ([09:31](#)):

So looking ahead, do you see anything that could increase interest rates substantially? Maybe that's tapering, which we all remember the Taper Tantrum and that-

Lara Rhame ([09:40](#)):

Yeah.

Kara O'Halloran ([09:40](#)):

Could be a thing that happens sooner than later tapering, not necessarily a tantrum.

Lara Rhame ([09:44](#)):

Right.

Kara O'Halloran ([09:44](#)):

So I'll leave you to talk about that.

Lara Rhame ([09:46](#)):

I think it's important to keep in mind that inflation and interest rates are related and they are going to continue to orbit each other at times, really knocking into each other. Because the fed is now laying the groundwork to probably start tapering their asset purchases. To start at some point, probably not for a very long time, but to start raising interest rates. That alone is enough to cause volatility in the markets and in interest rates. But now you're going to see volatility in the inflation numbers. And let's face it, we've gotten pretty used to boring inflation numbers over most of the 2010s. So it could really start, and it has been, moving significantly and needing some deeper dissection and all of that could amplify interest rate volatility. So, these two things are absolutely connected. If markets start getting concerned that inflation is not going to be quote "transitory", or they start maybe taking on board, the idea that transitory is going to be well into 2022, that could very well cause long-term interest rates to move higher.

Lara Rhame ([11:07](#)):

We still got interest rates in Europe that are negative in the ten-year, five-year tenor. So how far could interest rates rise? I don't think we're going to see a quick snap back up to anything like we're used to from 10 years ago. The reality is, we're still talking about a world where if U.S. rates rise, globally there's going to be demand to buy those assets. But I think at the end of the day, we're going to continue to see this mismatch between what we think markets should be worried about inflation and all of the factors that are really keeping long-term interest rates low. And at the same time as investors, we could really be dealing with some inflation numbers that are higher than we're comfortable with.

Kara O'Halloran ([11:58](#)):

Yeah. And, and I think that from the market side of things, as you said, just interest rates are really driving everything, at least in my view right now.

Lara Rhame ([12:06](#)):

Yeah.

Kara O'Halloran ([12:07](#)):

But we have started to see... I think back a couple weeks ago we had the Consumer Sentiment. One of the surveys came out. I think it was the University of Michigan survey. And Consumer Sentiment was weighed down by inflation expectations.

Lara Rhame ([12:19](#)):

Absolutely.

Kara O'Halloran ([12:19](#)):

And we saw a pretty risk-off day.

Lara Rhame ([12:21](#)):

Yeah.

Kara O'Halloran ([12:22](#)):

We're kind of getting this whipsaw around interest rates and inflation. Of course, markets continue to make new highs-

Lara Rhame ([12:29](#)):

Right.

Kara O'Halloran ([12:29](#)):

But you know, we're seeing some periods of risk-off therapies to all this.

Lara Rhame ([12:34](#)):

Maybe, the best way to express that exactly to your point, Kara, is that just because interest rates are low, does not necessarily mean markets are ignoring inflation and absolutely the economy is not ignoring inflation. You're seeing it impact households. You're seeing it impact businesses. And I-

Kara O'Halloran ([12:54](#)):

I mean, I heard the pain in your voice when you said you had to buy a car. I knew exactly.

Lara Rhame ([12:58](#)):

Exactly.

Kara O'Halloran ([12:59](#)):

I'm like, oh my gosh.

Lara Rhame ([13:01](#)):

Yeah, inflation's complicating a lot of our lives at this point. So, it's not a topic to ignore and it absolutely will be front and center in the coming quarter. And I think for several quarters afterwards.

Kara O'Halloran ([13:13](#)):

Yeah. Well, I said it before and I'll say it again. I am sure we will be back to talk about inflation again at some point this year.

Lara Rhame ([13:22](#)):

Yep.

Kara O'Halloran ([13:23](#)):

But in the meantime, Lara, it sounds like, even if we do continue to see inflation rising, we're not expecting interest rates to necessarily follow suit. Is that correct?

Lara Rhame ([13:33](#)):

That's exactly right. I mean, I think as we watch the feds start to be more specific about their tapering expectations, about any possibility of raising interest rates, we're going to see markets that are still really at the end of the day, driven by a lot of the structural factors that have pushed interest rates down over the last three decades. And we're also going to see globally low-interest rates. Just this magnetic pull down for U.S. interest rates as well. And finally, keep in mind that if we do get interest rates, sort of spiking higher, I don't expect another Taper Tantrum. I hope the feds learned their lesson, but it's certainly a fraught environment for some miscommunication. I think even if we don't see another Taper Tantrum, remember we are sort of at peak growth right now, our recovery is going to continue for some time, but growth will decelerate.

Lara Rhame ([14:40](#)):

It's not an outlook for weak growth, but it won't be as strong as it is right now. With all of this really eye-popping GDP growth that we've had, interest rates still not really risen sharply. So, all of that gives us an outlook where I think you could see tenure interest rates below 2% for a very long time. And that's what I think at the end of the day as concerned as investors get about inflation. They still need to think about returns that are going to keep pace with this higher inflation. I mean-

Kara O'Halloran ([15:18](#)):

The real yield on the 10-Year Treasury just hit an all-time low yesterday.

Lara Rhame ([15:22](#)):

Exactly. I think it's easy to forget and it's something that's very front and center for investors. The impact that... The difference between 2% inflation and 3% inflation is huge when you're looking at bond yield returns of, 1% income-

Kara O'Halloran ([15:43](#)):

Exactly.

Lara Rhame ([15:44](#)):

at 1% on your sort of traditional fixed income.

Kara O'Halloran ([15:46](#)):

Oh yeah. Of course this whole conversation, just speaks to everything we've talked about. About the need for income, the search for yield, and how difficult it is. 1.5 yield on the ten-year, even if it gets to that, that's not enough income.

Lara Rhame ([15:59](#)):

Right, right, right. That's absolutely right.

Kara O'Halloran ([16:01](#)):

You need a fixed income. So that definitely remains a challenge.

Lara Rhame ([16:03](#)):

That's absolutely right. I think it really all just speaks to the continued push into credit assets and to inter-risk the assets.

Kara O'Halloran ([16:13](#)):

Anything that has... Yeah. Anything with some yield on it.

Lara Rhame ([16:16](#)):

That's the investor not ignoring inflation. Right.

Kara O'Halloran ([16:20](#)):

Absolutely. Yeah.

Lara Rhame ([16:21](#)):

Even though markets have low inflation investors are absolutely-

Kara O'Halloran ([16:24](#)):

It's hard to ignore.

Lara Rhame ([16:25](#)):

and rightly focused on it.

Kara O'Halloran ([16:25](#)):

Yeah. Right. It's hard to ignore your 1% yield so.

Lara Rhame ([16:29](#)):

Yeah. Yeah.

Kara O'Halloran ([16:30](#)):

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It makes it makes total sense. Yeah. All right. Well, Lara, thank you so much as always for joining and we will be back again soon. I'm sure, to talk more about inflation.

Lara Rhame ([16:40](#)):

Absolutely. Thanks, Kara.

Speaker 3 ([16:50](#)):

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