SSI Investment Management

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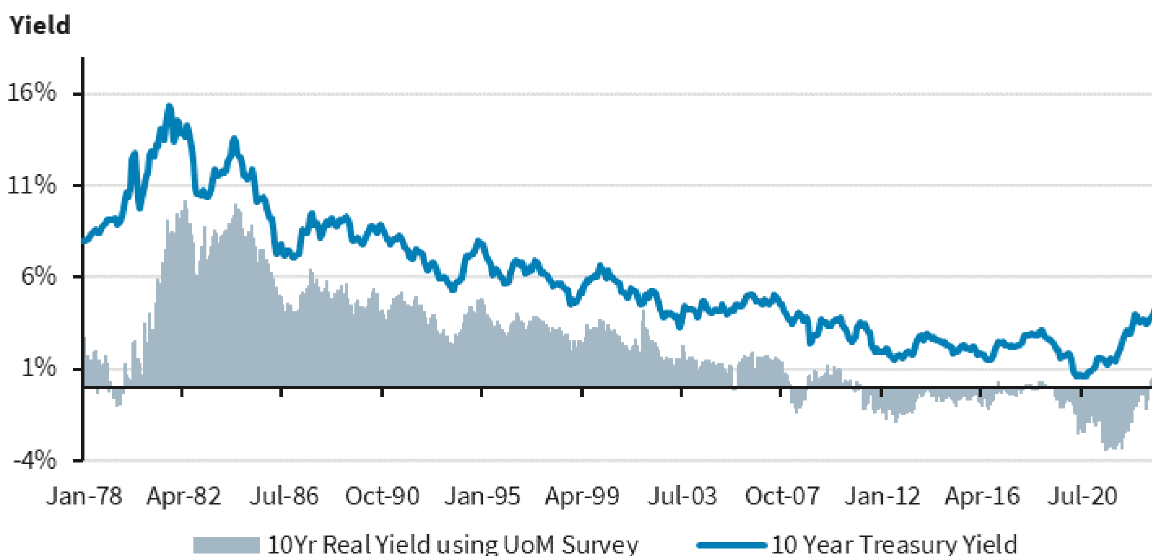
## Real Interest Rates Aren't That High, and Neither are Equity Markets

**Market Insights from:**
**George Douglas, CFA,** Managing Principal, Chief Investment Officer

While the magnitude and rapidity of change in interest rates has been dramatic, current levels of real interest rates are not particularly high versus past levels. Note, in particular the 20-year period of the 80's and 90's, in which real yields were significantly higher than they are currently. The average real yield on the 10-year treasury for those two decades, using the University of Michigan inflation survey, was 4.9%. In spite of the sharp change from the negative real yields of the last couple of years, real yields are nowhere close to those past levels.




*Source: Barclay's Research*

Over that 20-year period of 1980 through 1999, real GDP grew at an annualized rate of 3%, both a positive outcome and in line with historic real growth[1]. For equity investors over that same time frame results were quite strong. From the end of 1979 to the end of 1999, the S&P 500 with dividends reinvested grew at a compound annual rate of 17.9%. At that rate of appreciation, a dollar invested in the S&P 500 at the end of 1979 and held for the next twenty years with dividends reinvested would have grown to $25.79.

The focus by economists and investors on the *magnitude of change* in interest rates instead of the *level* of real interest rates perhaps explains the consensus forecast of recession last year which did not materialize. What is missing is that we have come from a period of extraordinary central bank intervention both in the short and longer end of the treasury curve. Because of the extraordinary magnitude of this intervention, it is difficult to predict its impact based on past data. The bottom line is that while recessions are always a risk, the risk of recession in 2024 is probably no higher than average.

Turning to equity markets, the strong returns of 2023 mask the fact that gains were mostly a recovery of losses from 2022. Note the table below:

| Total Returns | Full Year 2023 | 2-Yr Return 2022-2023 |
|---|---|---|
| S&P 500 Index | 26.3% | 3.4% |
| Nasdaq 100 Index | 55.1% | 4.9% |
| Russell 2000 Index | 16.90% | -7.0% |

The bottom line here is that equities have not done much over the last two years. It is difficult to describe equity markets as ahead of themselves.

Given a likelihood of moderate economic growth with recession risk no greater than average, and inflation receding, Fed policy could very well shift to accommodative versus restrictive. Equity investors could see movement into record territory for equity indices, and fixed income investors could finally have a chance to earn positive returns above the rate of inflation.

*Notes/Sources:*

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[1]*Source: Fred Economic Data St. Louis Fed*

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