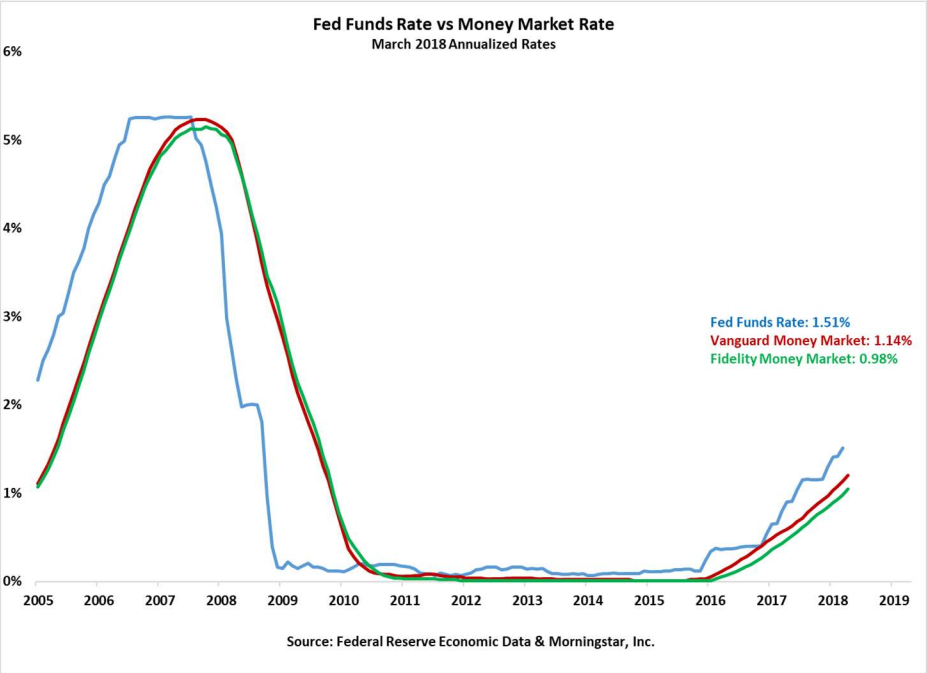
VICTORIA
Capital Management, Inc.

Interest Rates, Inflation and The Stock Market

Earlier this year the rationalization for increased volatility in stock prices was fears over tariffs and trade wars. Recently, market pundits attribute volatility to a rise in interest rates -- specifically the 10-year U.S. government bond rate that rose above 3%. The theory is that rising interest rates will lead to a slowdown in the economy, even a recession, so traders decided to abandon an aging stock market rally that is over nine years old.

Interest rates represent the cost of lending and/or borrowing money. There are two sides to the interest rate "equation": one is the effect on borrowers and the other is the effect on savers and/or lenders. Commentators on interest rate fluctuations seem myopic by only focusing on the negative effect of higher rates on borrowers. For example, mortgages will become more expensive that could cause a slowdown in housing, car loan rates will rise that might affect auto sales and credit card borrowers will be penalized by higher rates. More to the point, the monetary textbooks tell us that Fed policy regarding interest rates is focused on slowing the rate of growth in commercial and industrial loans, a key factor that drives a stronger economy through restraining business borrowing.

On the other side of the equation, rising interest rates have a positive and, maybe even offsetting economic effect, on the impact of higher interest rates on borrowers. When the Federal Reserve raises short-term interest rates through a higher fed funds rate, other short-term rates follow. One manifestation of this increase is in the basic prime rate, the favored rate that banks lend to commercial clients. Another, perhaps more important effect of this higher fed funds rate is the increasing yield on money market funds, a favored savings vehicle for individuals.



There are trillions of dollars invested in money market funds. As short-term interest rates rise, these money market funds experience a related rise in yields that leads to higher interest payments to savers. We have yet to see any mention in news media about how much income savers lost when the yield on money market funds went from over 5% in 2007 to almost zero as can be seen in the exhibit on the prior page. These savers were penalized over the past eleven years. Now that rates are on the rise, the increased income savers receive could contribute to economic growth as people have more disposable income.

A similar conversation is taking place about concerns over rising inflation. One definition of inflation was "too much money chasing too few goods" but that definition fell into disrepute as the Federal Reserve ballooned the money supply (quantitative easing) in response to the financial turmoil in 2008-2009 and inflation remained below 2% for years after that monetary expansion.

The latest gambit to scare investors and politicians is an imminent surge in inflation due to rising wages. Blaming rising incomes seems to be an easy way to get a boogeyman should there actually be an increase in inflation. Taking a step back, this shift of "wealth" from corporations to workers doesn't produce inflation, rather one sees a shift in wealth from one economic sector to another without any inflationary implications. Such shifts take place every day and with an accelerating economy there will be sectors that experience price increases because of rising demand. There will also be one or more that will experience falling demand. Unless there is an actual shortfall in supply, these shifts are normal in an expanding economy. Another factor affecting inflation is the government's efforts to reduce regulation that has been a major contributor to inflation but is not included in traditional evaluation of government intervention in the economy. Now that regulations have been reduced so have inflationary pressures.

To complicate the accurate measurement of inflation, growth in information technology and innovation is wreaking havoc on the measurement of "worker productivity" (the change in output per manhour). For example, how does one measure the value added of GPS or Uber or Apps that let you pre-order items for pick up rather than standing in line? It is impossible to measure the exponential increase in productivity from just these few services! Moreover, the collapse in the cost of computer memory and large screen TVs is not accurately reflected in traditional measures of inflation.

If interest rates and inflation are not the threat to the stock market that current pundits make them out to be, what expectations can we have for the stock market given this short-term volatility? If these "threats" prove to be as transparent as we make them out to be, investors will revert to the basics—growth in corporate revenues, profits, increasing dividends, mergers and acquisitions and the unmatched rise in corporate wealth. As usual, expect the talking heads to focus on the perceived negatives associated with rising interest rates and higher inflation. Unfortunately, they will not spend sufficient time discussing and analyzing the positive effects on the stock market of a return to capitalism with less regulation and government intervention.

Diane V. Nugent, *President/CEO* Thomas E. Nugent, *Executive Vice-President*