The era of very low inflation and interest rates may be near an end

By Neil Irwin
April 26, 2018 – *The New York Times*

For years, the world economy has been trapped in a low-inflation, low-interest-rate rut. Yet the latest shifts in global markets suggest that this could, at long last, be ending.

The evidence isn't definitive. This could be a false dawn, of a type that has happened a couple of times in recent years. But let's put it this way: If the world economy *was* coming out of its low-inflation funk, this is probably what it would look like.

In recent days, the rate the United States government must pay to borrow money for two years has reached its highest level since 2008, and on Tuesday the yield on 10-year Treasury bonds rose above 3 percent for the first time in four years. As recently as September, that rate was near 2 percent.

You see a similar pattern in the bond prices of other advanced nations. For example, German 10-year yields rose to 0.64 percent Wednesday from 0.31 percent in September.

If this really is the start of a resetting of inflation and interest rates toward more historically normal levels, it will be mostly good news for the world economy. Central bankers have spent years trying unsuccessfully to get inflation to the 2 percent level many of them aim for.

In many ways the low interest rates of recent years have been a reflection of economic weakness around the globe. So as long as the moves don't go too far, increases in inflation and interest rates would be a sign the global economy is returning to a more prosperous equilibrium like the one that prevailed before 2008.

The shift looks to be driven mostly by a rise in investors' expectations for future inflation. In the United States, prices of inflation-protected bonds imply that investors currently expect consumer prices to rise 2.09 percent annually over the next five years, up from 1.65 percent expected in September.

That, in turn, partly reflects a sharp run-up in oil prices over the same period, which seems likely to push up consumer prices for gasoline and other fuels in the months ahead. But strikingly, inflation expectations for the period between five and 10 years from now have also risen, when the impact of the recent oil price rise should have long since passed.

A number of factors are involved in this shift. Economic growth is solid across almost all of the world's major economies for the first time in a decade, meaning there should be upward pressure on demand for all sorts of raw materials.

And with the United States closing in on full employment (or arguably already there), the Federal Reserve is looking more confident than it has in years in its intentions to keep raising interest rates.

Trump administration policies may also be playing a role.

New tax cuts and spending legislation will result in hundreds of billions of dollars more in Treasury bonds being issued in the years ahead than had seemed likely not that long ago. This means the government may need to pay higher interest rates to find buyers of that debt.

And if threats of a trade war with China or other countries turn into reality, this will tend to increase inflation, driving up prices both directly through new tariffs on imported goods and indirectly by encouraging less efficient production.

All of those forces are doing battle with longer-standing pressures in the other direction that have been in place since the global financial crisis a decade ago. This includes a chronic shortage of demand for goods and services and declining growth in the working-age population in many rich countries.

There have been fake-outs in bond and commodity markets on this front before, including in the second half of 2013 and in the months surrounding President Trump's 2016 election victory. This could be another one, and reverse itself soon enough.

But in the meantime, you can view the higher volatility in the stock market in the last couple of months as a consequence of this standoff between forces of inflation versus deflation, between higher interest rates and lower rates, and between a world economy straining against the limits of its capacity versus one that still is working through chronic oversupply.

On Tuesday, when long-term Treasury rates soared, the stock market fell, as investors tried to assess the consequences of this higher-rate environment for stocks.

After nine years of economic expansion and rising stock prices, the market is richly valued relative to earnings. Each $100 invested in the Standard & Poor's 500 currently generates only $4.78 in earnings at Tuesday's closing price. That low return might be tolerable when money invested in an ultrasafe Treasury bond — or even in a savings account — generates very low returns.

If higher interest rates are caused by higher economic growth, that's a dynamic stock investors would probably be fine with, in that more growth should translate into more corporate earnings. But if the rates are being driven by inflationary pressures, that's a different story, and suddenly the assumptions behind sky-high stock prices could fall into doubt.

As a reminder, stock market volatility skyrocketed in early February upon publication of new wage data suggesting that inflation pressures might be building, which could prompt the Federal Reserve to raise interest rates faster.

In the short run, markets can be shaped by all kinds of things, whether algorithmic trading or a run of bad news for a major company or a presidential tweet.

But in the longer run, economic fundamentals are powerful forces. And if this really is the turning point toward something more closely resembling the pre-2008 inflation and interest rate environment — still a big if — it will have an impact for nearly everyone, not just people with money to invest.