OUR TWO CENTS

18 JANUARY 2024

MICHAEL CAROLINE

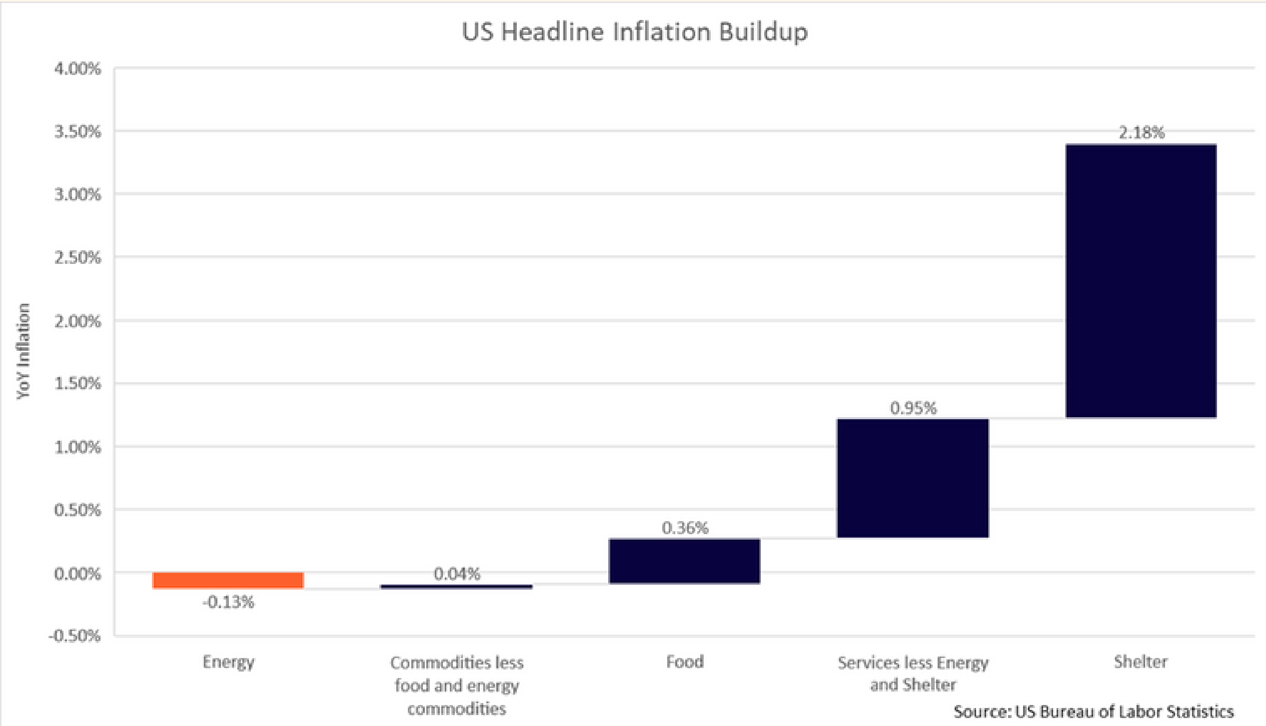
BCom (Hons) Investment Management (UP) | MPhil in Finance (UP) | Passed CFA Level 3

Michael joined as an investment analyst and has an MPhil (Financial Management Sciences) cum laude specialising in economic psychology and has passed the CFA level 3 exam. Prior to starting at New Road Capital, he worked as assistant lecturer at the University of Pretoria assisting with quantitative investment analysis. He has built and traded on models using CFDs. Outside of work, he enjoys flying motor gliders from Springs airfield as well as sailing his Laser class sailboat.

Interest Rates and Inflation Components

By Michael Caroline

The past two years have seen the US Federal Reserve bank rapidly raise interest rates to combat high inflation. Interest rates are a key tool used by central banks to bring down inflation, although this comes at the cost of economic activity. When interest rates are lowered again, economic activity increases create an ideal environment for most asset classes to perform well. The question now is, when will the Federal Reserve decide that rates have been raised high enough to cool off inflation and lower them to a long run rate and will this happen without the higher rates pushing the US into a recession? To answer this question, one must consider the components that make up the inflation figure, what the largest contributors are and how raising rates further might impact them.



A breakdown of the US Inflation figure is presented above and illustrates how shelter is the largest contributor adding about 2.18% to the inflation print of 3.40%. The inflation in shelter is largely driven by inflation in rent which is tied closely to interest rates through mortgages. As mortgage rates increase, rents are typically increased to cover the higher payments. While this adds upward pressure for some time, property prices eventually begin to fall as fewer people can afford to buy at higher rates and as rent stabilizes at a higher level. Thus, although the effect is initially inflationary, the long run inflation rate of the shelter component should be substantially lower, bringing inflation closer to the Federal Reserve's target of 2%.

This data strongly supports the view that we are at the top of the interest rate cycle and can expect rates to decrease during the year. It is important to be correctly positioned to take advantage of this move, particularly as a soft landing, when the Federal Reserve brings inflation down without pushing the economy in to a recession, becomes more likely. This scenario is likely to result in strong performance across all asset classes and an investing environment that one would not want to miss out on.