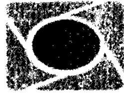

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# **Interest Rates**

July 2013

Stock market equities have been acting erratic for over a year. Much of it due to decreases in interest rates which worked to the favor of Wall Street up to now.

From July 2012 to July 2013, the 10 Year Treasury has increased from 1.4% to 2.5%; a 78% increase in a year. In the last 60 days (as of July 2013) interest rates increased from 1.8% to 2.5%; a 39% increase. We could well be looking at a spike in the 10 Year Treasury to 3.25%-4% as early as next year! These increases are not market driven as the norm should dictate. They were artificially driven by the Federal Reserve's stimulus which has created feckless equity market behavior in Wall Street stock pricing. There is absolutely no reason for these excessive stock valuations based upon the current U.S. economic state of affairs, corporate fundamentals or to otherwise justify this overly emotional and apprehensive behavior pattern other than low cost, yield driven investor money with nowhere else to put it. To substantiate this fact, when corporate earnings come out over the next two weeks many corporate gross revenue streams will be flat and their profit margins thinner than before, yet S&P earnings multiples will be as high as 18x!

Do not be at all surprised when, in September/October, the Fed partially dials back its U.S. Treasury Bond purchases of U.S. debt. Interest rates of short, immediate and long term treasuries will likely <u>temporarily</u> spike from 70 to 150 basis points higher than now and then stabilize back into more normal rates with a more typical correlation to *real* (not nominal) U.S. growth patterns once again buck in play. This up-spike may last 120-180 days and the consequence is that these erratic interest rate increases will potentially have a huge impact on CMBS/RMBS/CDO risk spread increases between October 2013 and March of 2014 before settling back down. Get your financing done now or otherwise wait till next spring.

## **Flow of Funds into Real Estate**

Since 2011, the U.S. Stock and Bond markets have been flush with cash proceeds from all sources of worldwide investors including Sovereign Wealth Funds investing current account surplus funds produced from their own country here in the U.S. And why not; with our short term interest rates at near zero, intermediate rates (1-3 years) at 1.5% and long term rates at 3-4%, corporate profit generation is provided every advantage in which for them to soar as their borrowing and debt carry costs are minuscule.

But since November of 2012, even though corporate earnings were increasing, corporate revenues have been flat <u>and</u> profit margins decreasing. Yet, since January 2013, the Standard and Poor's index has increased over 14%! Go figure. A realistic answer can be that corporate America has laid-off workers, rehired part time workers and also

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refinanced more expensive debt with cheaper debt at today's low interest rates. These cost cutting measures lowered their costs and temporarily created higher earnings.

To compound this trend of flat revenue increases, tighter profit margins yet higher corporate earnings, the stock market has also experienced multiple wild swings up and down since the first of the year. Why the swings? First, investor uncertainty of the sustainability of the Federal Reserve's stimulus schemes of the last four years keeping interest rates artificially low, has and is continuing beyond what the investing public really expected and Second; the proliferation of stock market computer driven trading, micro-speed trades by specialist companies that speculate in this sector are now spooking the mom and pop investor. These automated computer trades now comprise 60-70% of the Stock Market Volume! You may have to conclude, much of the volatility in Wall Street markets is currently caused by algorithms and pre-programmed computer trading formulas which has also cut out the individual small investor as an equal player. Thus, less liquidity that would otherwise be there. The added market liquidity created and claimed by computer traders and high-speed traders as a presumed benefit of this trading activity is a weak argument. Does then the typical investor have an even chance to really profit unless he only plays an index fund?

The end-game of the fickle and erratic actions of stock market behavior and the absence of not one scintilla, of sustainable economic fundamental stock valuation hard data, and the reduction in stimulus funds to prod our economy with low cost funds, bode strongly for a significant shift of Wall Street investor money into high-end, well located real estate once investors reappraise the substance of their portfolio valuations and the real current conditions of the underlying national economy.

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