Are interest rates at risk of choking off growth?

The real fed funds rate only recently moved near positive territory, after remaining below zero for several years. History suggests that the onset of recession is unlikely with real rates still this low.

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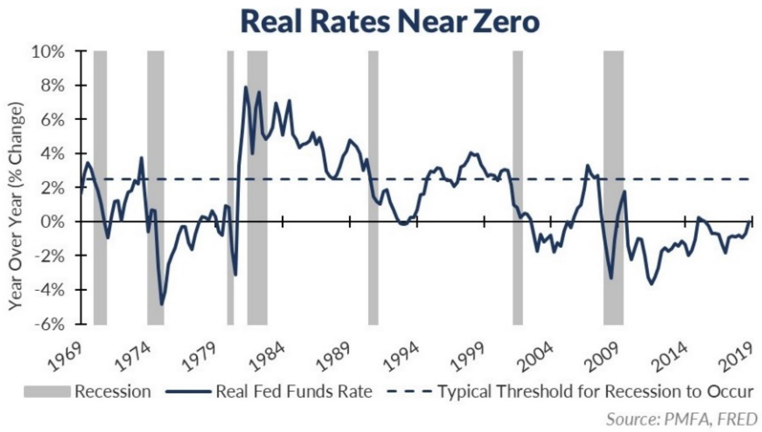

Despite the Federal Open Market Committee raising the fed funds rate nine times since 2015, short-term interest rates remain relatively low by historical standards. Even lower still is the real (inflation-adjusted) fed funds rate, which provides additional context around the current rate environment. Despite those previous hikes, the real fed funds rate is currently near 0%, only recently edging back toward positive territory, after being negative for most of the past decade. So why does this matter?

As an economic expansion advances, tighter conditions lead to growing price pressures, prompting the Fed to increase rates to let some steam out of the economy. This generally leads to higher real rates, and – at some point – an end to the expansion. Today, with inflation still quite stable near 2%, the Fed is reasonably well positioned to keep rates lower for longer, unless actual inflation heats up or inflation expectations begin to edge higher. Neither appear problematic in the near term.

It's also worth noting that, aside from the recession in 1981 when inflation was spiking sharply and the Fed arguably fell behind the curve in raising rates, the real Fed Funds rate has been above 2.75% before the onset of a recession – well above the current real rate near 0%.

Despite the hikes that have occurred in recent years, short-term interest rates remain low and inflation remains in check. It's possible that both will edge higher as the current expansion continues to mature and conditions tighten. For now though, the rate environment still appears to be supportive of continued growth.

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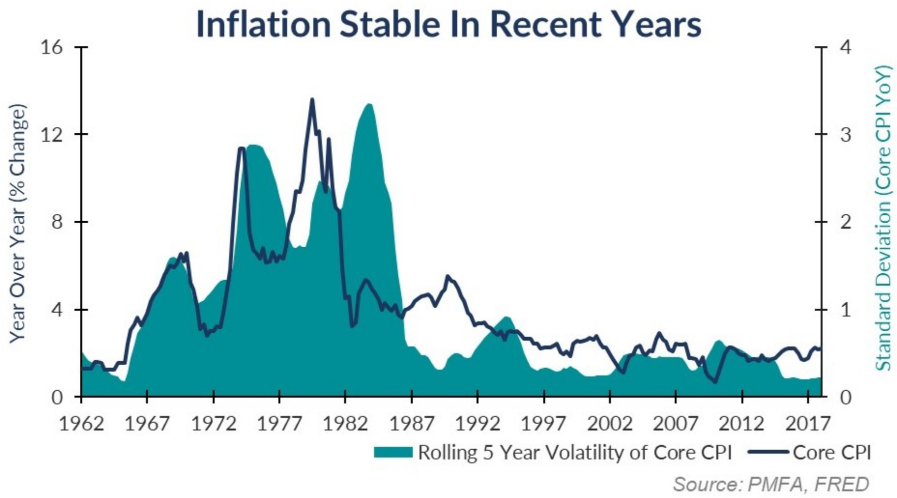
Should investors be concerned about inflation?

While high and volatile inflation has been a problem in the past, the last few decades of low and stable inflation has been positive for the economy, and for investors planning for their financial future.



Low, stable inflation is an important underpinning for both the economy and capital markets. Stable prices boost consumer and business confidence, enabling them to make decisions without allocating time and resources in efforts to protect against the loss of purchasing power.

For over twenty years extending from the 1960s to the 1980s, inflation was not only much higher, but also exhibited much greater volatility, making investment decisions much more challenging. After peaking in the early 1980s, inflation slowed meaningfully in the years that followed. Having declined to a more sustainable range, inflation has been comparatively stable over much of the past three decades.

In recent years, some had voiced concerns about the potential inflationary impact of exceptionally low rates and quantitative easing. Instead, inflation has remained quite low; over the past year, the core Consumer Price Index has barely budged, remaining just a touch over 2%. This tame environment for inflation gives the Fed greater latitude to be patient in raising rates further, which should in turn provide continued support to the economy and reduce the risk of overtightening.

Certainly, inflation (and the potential impairment to long-term purchasing power) is a risk that should be considered when developing a financial plan. Relatively low, stable inflation makes that process easier. It should also be reassuring for anyone attempting to plan for specific future expenditures or, more broadly, investors planning for their retirement or other long-term financial goals.