



ECONOMIC COMMENTARY

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*For every one to attain
financial well-being*

THE EVOLVING INTEREST RATE LANDSCAPE

The first interest rate cut by the Federal Reserve (Fed) has happened and now the focus has shifted from “when” to “where”: Where are interest rates heading next? This shift is more than a mere change in phrasing; it is a sign of the evolving economic landscape, with real consequences for growth, investment, and employment.

The path of interest rates affects every corner of the economy, from the cost of borrowing for a home to whether companies invest in new projects. Economists use the term “neutral real Fed policy rate”, or R-star, to describe the level of interest rates that is neither too stimulative nor too restrictive for economic growth. This is a kind of Goldilocks zone: Not too hot, not too cold, but just right.

In 2018, inflation was on target at 2% and unemployment was low. The Fed raised its policy rate to 2.5%, translating to a real rate of about 0.5%. Many viewed this as the new normal for monetary policy. But the financial landscape has changed since then. The yield curve (a key indicator used by economists to determine where rates are headed) has shown unusual trends, making this moment different from the past.

Before the global financial crisis, real policy rates typically hovered around 2% but, now, projections suggest a target for the funds rate of about 3% once inflation stabilises at 2%. However, determining the neutral rate today is more challenging, particularly as the world wrestles with new forces like rising government debt, shifting demographics, and the transformative power of artificial intelligence (AI).

Some experts believe that the neutral rate needs to be much higher than the pre-pandemic 0.5% level, citing factors such as rising deficits, which require higher interest to attract investors, and the prospect of an AI-driven productivity boom, which could increase demand for loans. If companies need more money to invest in technology and innovation, interest rates might need to rise to balance that demand.

There is also the term premium to consider. The term premium is the extra return investors demand to hold longer-term bonds instead of shorter-term bonds. Typically, the yield curve has a positive slope, meaning rates increase over time to compensate investors for holding longer-term debt. However, recent inversions (where short-term rates are higher than long-term rates) have caused confusion and concern. These inversions are likely a temporary distortion rather than the new normal.

The yield curve is expected to adjust by steepening (where long-term rates rise relative to short-term rates) to attract enough buyers for the growing pile of government bonds. Investors will demand a higher term premium, meaning that they will want more return for holding bonds for longer. For fixed-income investors, this could be a positive development. They might be rewarded not only for the interest rate risk that they bear but also enjoy the hedge that bonds provide when the economy hits a rough patch.

What does this mean for interest rates in South Africa (SA)? The Fed’s actions often have significant ripple effects on emerging markets, including SA. As United States interest rates adjust, SA may face increased pressure on its own rates to maintain investor confidence and manage capital flows.

The evolving interest rate landscape is a story of change; a story that affects each of us differently, depending on our place in the economy. But, as with most things, change also brings opportunity. For those willing to adapt, the shifting contours of rates, yields, and economic policy could open new doors to financial security and growth.

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