What is the Market Telling Us About Interest Rates?

This week marked the latest US Federal Reserve meeting, where they announced that short term interest rates would remain unchanged. The market places significant emphasis on these announcements, with investors eagerly awaiting every word. However, the question arises: **Is this truly a critical concern for long term investors?**

Ultimately, market participants are best placed to determine the price of goods, including money, rather than relying on centralised authorities. Even in the US, where the central bank adjusts short term interest rates and employs various tools to stimulate the economy or try and curb inflation, its the buyers and sellers in the marketplace who ultimately "decide" on the optimal interest rate.

Efficiency thrives in markets with a substantial number of buyers and sellers and the **US debt market** ranks among the **world's most efficient** for several reasons:

- Size: The US government is the largest global borrower.
- Liquidity: Measuring how easily assets can be bought and sold.
- Regulatory Environment: The market benefits from a relatively stable political environment
- Dominance: At this point, the US dollar retains its status as the world's reserve currency.

Examining the current yield (or market interest rate) on the US 10-year bond, at approximately 4.75%, we can break it down into **two key components.**

Firstly – **inflation expectations**. All lenders seek compensation for potential future inflation on the money that they lend. The most recent rate stood at 3.7% year-on-year, yet the market implies that it will average 2.4% over the next decade.

Secondly – **a risk premium** must be factored in, to reward investors for various risks, including default, liquidity, and term-related risks. It's this component which provides lenders with their actual real return over time. Historical data from Credit Suisse spanning 123 years indicates an average real yield of 1.7%, while the current implied rate is higher at 2.35%

Conclusion

At face value, the market-determined rate appears relatively enticing for cautious investors. Nevertheless, the world is currently in a significantly different state compared to the last 20 years, with soaring debt levels and heightened geopolitical tensions. In the end, only time will tell whether investors were fairly rewarded for all the risks, especially the risk of inflation.

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