The secular decline in long-term rates that began in 1982 resulted primarily from a decline in the inflation expectations associated with a sustained disinflation. However, as inflation approached zero after the 2001 economic downturn, policymakers became concerned about their ability to deal with a potential deflation. Short-term interest rates were taken down and kept near or below inflation, and the FOMC’s policy statements emphasized its intent to keep rates low for a considerable period. Such an emphasis probably kept long-term rates low.

The continued stability of long-term nominal interest rates at relatively low levels over the past year has been described as a conundrum. As the economy recovered and the threat of deflation abated, both nominal and real long-term rates were expected to rise. But real 10-year interest rates, as measured by rates on Treasury inflation-protected securities (TIPS), continued to fall relative to their nominal counterparts. Thus, expected inflation—measured as the difference between nominal and real interest rates—tended to rise. In part, this may reflect liquidity limitations in the TIPS market. On the other hand, survey data also suggest a slight upcreep in inflation expectations recently in the face of declining nominal Treasury rates.

Some recent downward pressure on Treasury rates may reflect a shift to quality. Holders of privately issued instruments have been demanding a greater premium for risk. Yield (continued on next page)
spreads between corporate bonds and 10-year Treasury notes have widened, especially for riskier assets such as high-yield bonds, commonly known as junk bonds.

Although yield spreads of mortgages over Treasuries also increased, mortgage rates remain quite attractive. Indeed, mortgage refinancing continues to be a good source of household liquidity. Moreover, low-cost financing helps sustain the current housing boom.

Ultimately, inflation and inflation expectations are contained because economic growth is supported by strong fundamentals. Robust productivity growth, in particular, helps keep unit labor costs in check. Labor costs account for almost two-thirds of total costs; hence, stable unit labor costs help subdue inflation.

Robust productivity relative to the rest of the world makes the U.S. an investment haven. This country’s financial markets are a favorite destination for the rest of the world’s savings—a factor that not only maintains downward pressure on bond yields but also exerts pressure on equity prices. Productivity gains translate into greater expected earnings growth and thus into promising returns on equities.

Indeed, earnings growth at the 500 largest U.S. firms has outstripped equity price increases, causing a substantial decline in the price-earnings ratio to a level below the post-1990 average. Moreover, earnings growth is expected to exceed the growth rate of the economy. Thus, the fundamentals suggest a favorable outlook for the equity markets.