THE YIELD CURVE, THE FED, & P/Es

Changes in short-term interest rates by the Fed, on their own, have minimal impact on stock market P/Es...unless the Fed is unsuccessful in controlling inflation or preventing deflation. Increases in short-term rates are intended to contain the inflation rate, the driver of P/Es and long-term interest rates, at levels of price stability. Decreases in short-term rates, often to stimulate the economy, must be done in a way that does not cause inflation or foster inflation expectations. The implication of an average yield curve spread of approximately 100 basis points (1%) is that the interest rate that relates to inflation expectations, the long-term rate, is likely to stay relatively low. When the spread exceeds 1%, the implication is a risk of potentially higher inflation and lower P/Es. Spreads below 1% imply tighter monetary policy and efforts to control inflation risks (yet this also creates the risk of deflationary conditions and lower P/Es).

Why? Short-term interest rates should be only slightly above inflation. If inflation is held to the Fed's goal of 1% to 2%, say approximately 1.5%, then short-term Treasurys should yield around 2% or less. Add 1% for the long-term spread and that implies bond yields near 3%. Even using the market's assessment of future inflation (currently around 2%), the resulting long-term rate would be less than 4%. Further, based upon Crestmont's "P/E Pinnacle" analysis, P/Es should stay in the low to mid 20's—except during periods of market disruption—but this is dependant upon the inflation rate being maintained at low levels reflecting price stability.