KLCM ADVISORS, INC

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Rates Gone Wild?

With the 10-year treasury yield exceeding 5%, many believe that interest rates are unsustainably high. Our view is that rates are simply returning to a more normal level. For nearly a decade and a half following the 2008 Global Financial Crisis, the economy operated within an unprecedented financial landscape. Central banks kept benchmark interest rates near 0% and injected trillions of dollars directly into markets by indiscriminately purchasing bonds, a strategy now known as quantitative easing. This prolonged era of cheap money eventually distorted public and market perception. It conditioned an entire generation of homeowners, investors, businesses, and government leaders to view exceptionally low interest rates as normal.

When central banks aggressively raised rates starting in 2022 to combat surging post-pandemic inflation, critics decried the move as an extremely punitive shock to the financial system resulting in the most dramatic yield curve inversion in decades. However, viewed through a broader historical lens, a very different reality emerges. The ultra-low interest rates of the 2010s were a historical anomaly—an emergency intervention that lasted far too long. Current interest rates represent a healthy return to normal.

When evaluating current benchmark rates against historical averages, the data shows that today's rates are remarkably average. In the United States, looking back across the modern economic era from the mid-20th century to the present, the long-term average of the effective federal funds rate sits between 4.5% and 5%.

A direct comparison across historical periods illustrates just how balanced current policy rates and their corresponding market valuations actually are:

Historical Era	Average Federal Funds Rate	Average S&P 500 P/E Multiple	Macroeconomic Context
The Great Inflation (1970s–1980s)	8.0% – 10.0% (Peaked near 20%)	Single Digits (7x – 9x)	Extreme monetary tightening needed to break structural inflation.
Great Moderation (1990s-2008)	4.0% – 6.0%	Mid-to-High Teens (15x – 18x)	Steady growth, moderate inflation, and stable economic expansion.
Post-GFC / Pandemic (2009–2021)	0.0% – 1.5%	Expanded (20x – 25x+)	Prolonged period of emergency stimulus; multiple expansion, low economic growth.
The Current Era (Mid-2020s)	3.5% – 5.5%	Normalizing/High Teens	Balanced normalization matching long-term historical medians.

The massive spike of the late 1970s and early 1980s was a clear historical outlier on the high side. The post-2008 era was an equal and opposite outlier on the low side. Today's rates sit comfortably in the middle, matching the steady-state periods of the 1990s and mid-2000s when the economy grew sustainably without collapsing or overheating.

While that period is associated with tremendous long-term results for financial assets, the current period faces a more difficult backdrop. Moving toward normal from high rates comes with a significant tailwind -- lower interest rates! These lower rates, while making borrowing cheaper, result in increasing bond prices and generally expanding multiples for stocks. Conversely, moving from abnormally low interest rates back to normal comes with the headwind of higher interest rates. All things being equal, higher interest rates cause bond prices and equity multiples to fall.

We have observed this in the fixed income markets for the past several years where the **total return of the Bloomberg Aggregate Bond Index (price plus income) has been cumulatively negative since the end of 2020.** Yes, over this nearly six-year period investors lost money in bonds. This incredible headwind was caused by the final stages of a bubble in bond prices driven by price insensitive central bank purchases. The persistence of this activity led investors to conclude that interest rates would never meaningfully rise. We did not share that belief. Instead, we actively managed fixed income portfolios throughout this period resulting in significantly positive returns for clients.

Looking ahead, interest rates are unlikely to rise dramatically, making fixed income more attractive. Using the 10-year Treasury as a proxy, yields would need to exceed 11% from current levels for investors to suffer another nearly six-year stretch of negative returns. Now that would be wild!

Equity markets, on the other hand, have enjoyed positive returns even as interest rates have risen. Earnings have increased sufficiently to offset the lower multiple that investors are willing to pay. The compression of P/E multiples back toward their long-term historical average of roughly 15x to 17x is not a sign of market failure, but rather a healthy recalibration. The question at hand for equity investors today is what will be the future growth rate of earnings. Markets are currently expecting earnings to grow approximately 25% this year and 12-13% each of the next two years. That level of growth would be generally supportive of higher-than-average multiples. The fly in the ointment, if you will, is that hitting those numbers is almost singularly dependent on continued capital investment into AI data centers and the subsequent increase in demand for semiconductors and related equipment. These “picks and shovels” are in short supply allowing producers to sell them at dramatically inflated margins to price insensitive buyers. Given record operating margins from “sold out” suppliers it seems hard to believe that this rosy scenario of earnings growth will come to fruition. When supply and demand for all things AI comes into equilibrium, it is likely that operating margins throughout that ecosystem will fall significantly. Given the disproportionate share of earnings growth this represents, much like the final stages of the bond bubble, the decline in margins and thus earnings will sow the seeds for a prolonged period of subdued returns in equity markets.

This does not change our simple belief that over any reasonable timeframe, the economy and earnings grow, enabling equity markets to move higher. Patient investors are ultimately rewarded, though patience is tried at times. Financial markets will continue to allow individual investors to accumulate wealth and achieve their financial goals. Perhaps Benjamin Graham said it best, "**The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavior discipline that are likely to get you where you want to go."** This is exactly the type of environment to achieve those goals. With interest rates closer to equilibrium and with equity markets having significantly outpaced the fixed income market over the past several years, now is a fantastic time to re-evaluate investment objectives and portfolio allocations.