After Considering Inflation, Interest Rates Seem Pretty High

People have been grumbling about interest rates lately. They note that the return is very low, and those that are living off their investments must spend their capital. However, in real terms, the return on interest bearing securities like Treasury Bills is really very good. Yes, those living off the returns of fixed income investments must spend some capital, but after adjusting for tax and inflation, they always have.

Using United States numbers to 1950, and Canadian numbers after 1950, we note the following arithmetic averages. From 1926 to September 30, 1996, Inflation has averaged 3.4 percent, Treasury bills have returned 4.6 percent and common shares have returned 11.4 percent. Real returns (return minus inflation) have averaged 1.2 percent for Treasury Bills and 11.4 percent for common shares. Maybe more significantly, if we divide the returns by the rate of inflation, we note that the returns on Treasury Bills have averaged 1.4 times the rate of inflation, and the return on common shares has averaged 3.4 times the rate of inflation.

So as you can see, if the historic return on Treasury bills has only been 1.4 times the rate of inflation, after taxes, most people would have been losing purchasing power. Actually, anyone in a tax bracket of thirty percent or more was losing purchasing power, without even spending any money. Now, lets see what the current returns are.

For the twelve months ended on September 30, 1996, inflation was 1.4 percent and Treasury Bills returned 5.7 percent. That equals a real return on Treasury Bills of 4.3 percent, when the historic return was only 1.2 percent. Again, more significantly, the return on Treasury Bills was 4.1 times the rate of inflation, when historically it was only 1.4 times. So today, even if you are in a top tax bracket, you will increase your purchasing power by holding Treasury Bills.

It is true that a person living off the income of their fixed income investments may still have to spend some capital, as the interest income may be insufficient. However, thanks to inflation and taxes, they always were, they just did not realize it. At least with today's rates, they have a fighting chance.

So as you can see, even though interest rates seem very low, they are really better than they have been in the past. So while we continue to recommend holding some equities for growth, we must also warn against running out and switching your fixed income investments for equities, just because interest rates seem too low.