



Modern investors should remember the nature of long-term interest rates has changed in the past 40 years, says *Forbes Magazine's* Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher – now they are completely free-market set

# The long and the short of it

They get it wrong because they think like it was 40 years ago. By "they", I mean all the folks who for more than two years were forecasting steeply rising long-term interest rates. In the US it is a serious mental illness. The continent too – and even here to some extent.

First, too many folks can't separate in their minds long-term rates from short-term ones. When the US central bank raises short rates, folks expect US long rates to rise too. Well, we have two years now disproving that. Everywhere short-term rates are controlled by a country's central bank – with no necessary effect on long rates.

Long rates are completely free-market set and the free market in which they are set is not that country but the global long-rate market. If global long-term rates head in one direction, long rates in the UK or the US can't bolt the other.

Not so 40 years ago with rigid currencies, national banks instead of global ones, minimal electronics and no futures to hedge. Then long rates were set freely but inside a country. People think like they still are – but they aren't.

Today's gross domestic product weighted 10-year government bond rate is 3.5% and has fallen almost steadily for years. As that happens, flat 10-year rates in the UK and the US look ever more compelling and relatively higher in global markets. So they're bought, bidding bond prices up and capping our rates from rising. This simple fact explains why gilt rates aren't higher than they are.

This doesn't fade soon and is bullish for stocks. As long as corporations can borrow 10-year money at pre-tax rates that are low compared to their after-tax earnings yield – the inverse of the price/earnings (P/E) ratio – firms will borrow and buy back their own shares endlessly and take over other firms as if they were money drunk, all of which bids up stocks.

If my P/E is 16, my earnings yield is six – an after-tax number. If I can borrow 10-year money at 6% and buy back my stock



I get the tax rate differential for free and my earnings per share rise – but the buyback boosted my stock. Anything with a real P/E under 22 can be bought back profitably – surely you've noticed this year's surge in stock buybacks and takeovers. This is the cause and it won't fade until either stock prices or global long rates are markedly higher – or both. Meanwhile buying stocks that can benefit – such as the following – is easy.

Dutch-based insurance giant **Aegon** could be acquired by a myriad of American firms for its US business. The largest insurer of any non-US firm, its cost are low and its sales capabilities better than most competitors yet it sells at prices allowing it to buy back shares or be taken over – 70% of revenue and nine times earnings, a whopping 11% earnings yield. Meanwhile I estimate a 2006 3.7% dividend yield.

**Archer Daniels Midland** in the US combines several great features. I'm bullish generally on food processors but this company is dominant in oilseed, corn, wheat and soybean processing. It has been farsighted in fuelling its plants with coal, which today gives a long-term cost advantage.

Finally, it is well situated in big emerging markets with capability in South America and Asia. Its trailing P/E of 15 is a 6.7% after-tax earnings yield. So, if it borrows long-term money at 6% and buys back its stock, it picks up 0.7% plus the tax-rate differential as free money – and drives up its stock.

**Banco Itau Holding Financeira** is Brazil's second largest bank not controlled by foreign sources, so it is ripe for acquisition. It is also ideally positioned in the country's wealthiest southeast – offering potential growth. Its 3,000 branches will be too much for someone not to acquire in the next few years.

A broad-brush US direct marketing-based insurer I like is **Metlife**. Direct marketers control their own destiny and Metlife's mail shots and direct response internet advertising generate leads for its huge direct sales force – making it the best such capability in the US. Its £23bn market capitalisation limits its potential to be acquired to true giants but, at 12 times earnings, it could – and should – buy back a lot of its stock, driving both the price and earnings per share up.

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