

Interest Rate Determinants

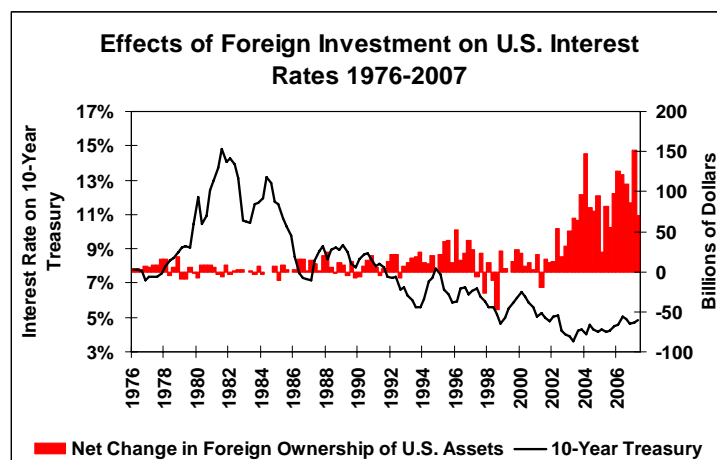
Recent developments in the global economy have sparked many debates surrounding the long-term impact on the U.S. economy. Globalization is in full swing and the U.S. manufacturing base has eroded while most underdeveloped countries are not enforcing international copyright laws. Despite all that is occurring, the U.S. has managed consistent growth over this transitory period. With interest rates near historic lows, much of the recent growth in the U.S. has been attributed to the favorable interest rate environment, for which underdeveloped countries are largely responsible. Will the cycle that has kept interest rates at historic lows continue?

By using relatively cheap currencies and abundant labor, underdeveloped countries are able to underbid most producers in the industrialized world's labor-intensive industries. The result is that most labor-intensive manufacturing operations have moved to underdeveloped countries, creating large inflows of cash from the developed world, usually in U.S. dollars. However, if an underdeveloped country

exchanged those dollars for their domestic currency, they would experience huge appreciations in their currency; consequently, they would lose the competitive advantage that was created by having a relatively cheap currency. As a result, underdeveloped countries

park those dollars in long-term U.S. debt, causing the price of bonds to rise and rates to fall, all while keeping the dollar strong.

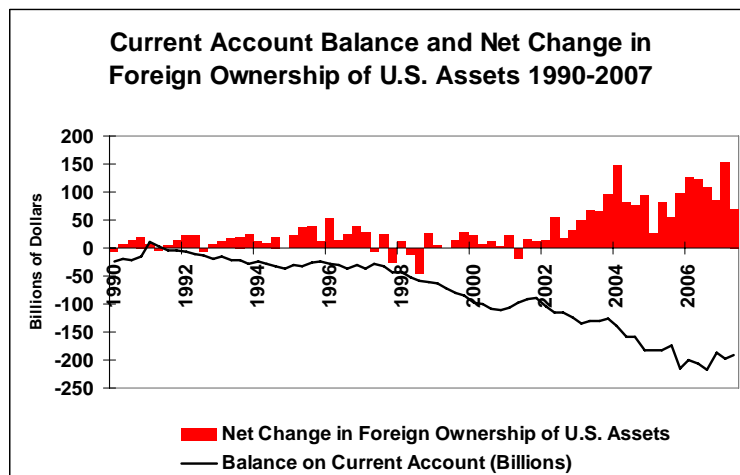
This Global Savings Glut, as Fed Chairman Ben Bernanke calls it, is primarily responsible for the low level of interest rates in the U.S., helping the U.S. sustain economic growth despite the loss of domestic manufacturing and jobs to underdeveloped countries. However, manipulating currencies by investing in U.S.



securities provides only a temporary solution for underdeveloped countries because the practice is fundamentally unnatural and detrimental to long-term growth. Although cheap currencies and abundant labor allow the underdeveloped world to prosper in manufacturing, the American consumer's inflated perception of wealth and insatiable appetite for cheap consumption goods is ultimately fueling their industries. The end of the stock market bubble in 2000 threatened to end the mentality that allowed many Americans to consume more and save less. In response, the Fed attempted to stimulate the economy by lowering interest rates and inadvertently created a new bubble in residential real estate, allowing many consumers to justify their consumption habits again. With the housing bubble deflating and home prices flat to falling in formerly hot markets, many consumers are finally reducing their consumption spending.

As the cycle of American consumption that fed the global savings glut slows and underdeveloped countries look to diversify their reserves into other countries and currencies, U.S. interest rates will begin to feel upward pressure as bond prices fall. Thus, the time of historically low rates may be ending.

However, rising rates and possible side-effects such as a recession will be accompanied by some



offsetting effects. Although an increase in interest rates will hurt market sentiment in the short-term, rising interest rates also cause the dollar to appreciate, making imported goods cheaper and helping to keep inflation down. The shift is part of a natural cycle that keeps the markets in long run equilibrium. After American consumption is put in check, markets will rebalance and the world economy, as well as the U.S. economy, will continue to enjoy stable growth through the upcoming decades.



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