NORTHEAST
INVESTORS TRUST

A No-Load Mutual Fund

Paying Dividends for Over 70 Years

The Fed: Finding Neutral

What is the "Neutral Rate"?

As all investors know, the Federal Reserve has been raising interest rates in the last year, and that has made cash investments more attractive and has negatively affected the valuations of bonds and stocks alike. But when will the Fed know it is time to stop raising rates? This depends, critically, on the so-called "neutral interest rate".

What is the neutral interest rate? It is the interest rate at which the economy is characterized by both full employment and stable inflation. Above that interest rate, the Fed is slowing the economy and reducing inflation. Below that interest rate, the Fed is accelerating the economy and thereby stimulating inflation. So this concept has an intuitive, practical appeal – the Fed will hopefully get to that level when inflation comes down, and the economy will see optimal employment and stable inflation. Of course, 2023 is no ordinary time. Inflation is too high now, and it is an explicit goal of the Fed to reduce inflation to its 2% target.

So how do we --- and the Fed --- estimate the neutral interest rate? Unfortunately, in an economy as complex as ours, there is no firm and easy way to calculate the exact neutral interest rate before embarking on monetary policy changes. We will know it when we see the economy in that optimal and stable position. However, most observers think that neutral is at a level that is a little above expected inflation. Accordingly, the Federal Reserve has raised its policy rate to 4.5%, and has signaled that it will increase interest rates a little bit further still.

A Moving Target?

Originally an esoteric concept, the neutral interest rate has garnered increased attention from practicioners in recent years. It gets mentioned now regularly on Bloomberg News and at Federal Reserve Press Conferences. In the prior decade, policy makers were surprised that lowering interest rates as much as they had done didn't stimulate the economy and inflation as much as anticipated, and so they avidly focused on the concept and concluded that the neutral interest rate had fallen. Unfortunately, the thinking that the neutral interest rate had permanently fallen led the Fed to be too late in raising interest rates, and that is one factor in why inflation has been so elevated recently.

Looking Forward

At Northeast, we believe that the Fed is in the process of marking up its estimate of the neutral rate, from 2.5% to between 3% and 4%. And the important implications of this includes that interest rates have had to rise more than anticipated, as well as that interest rates will settle at a higher permanent level even when inflation is tamed.

This of course has implications for all investors in all asset classes. Interest rates are the bedrock of finance, and higher core interest rates will pressure not only bond prices, but also equity P/E multiples, since both bonds and stocks compete for investor capital.

Henry Kaufman, the legendary economist at the preeminent bond firm, Salomon Brothers, once said: "The bond market will always outbid the stock market for capital". By this, he meant that wise stock investors also paid attention to the bond markets. It has been a long time since those days when we worried that governments would run deficits and, as price insensitive sellers of bonds to fund those deficits, those governments would crowd out other investments. Or are we returning to those days?

Financial market participants may have been lulled into complacency during the previous decade characterized by low interest rates, "forward guidance" that rates would continue to remain low, and extraordinary levels of central bank bond buying without regard to price. Those days are behind us now, and interest rates will have to find their own natural level. Where they will settle is crucially dependent on where the neutral rate is.

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (NTHEX), a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers in the industry, having run Northeast Investors Trust for more than 30 years.

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Mutual Fund investing involves risk. The Trust invests in lower rated debt securities which may be subject to increased market volatility based on factors such as: the ability of an issuer to make current interest payments, the potential for principal loss if an issuer declares bankruptcy, and the potential difficulty in disposing of certain securities in a timely manner at a desired price and therefore can present an increased risk of investment loss. Diversification does not eliminate the risk of experiencing investment losses.

Falling Interest rates and bond defaults may negatively impact the Trust's distributable income. In addition, during periods of declining interest rates, higher yield securities may be called and the Trust may be unable to reinvest those proceeds in similar yielding securities. Therefore, shareholders should expect the Trust's quarterly dividend distributions to decline under these circumstances. The Trust is generally for investors with longer-term investment horizons, and should not be used for short-term trading purposes. An investment in the Trust involves risk and should be part of a balanced investment program.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information about the Trust is contained in the prospectus or summary prospectus, either of which may be obtained by calling 1-800-225-6704 or by visiting www.northeastinvestors.com. Please read either one carefully before investing.

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