NORTHEAST INVESTORS TRUST

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A Rising R-Star?

A recent Wall Street Journal article dedicated itself to the topic of "R*" (pronounced "r-star"), which is the academic term for the so-called neutral interest rate. But what do we mean even by the "neutral interest rate"? The neutral interest rate is the interest rate at which inflation and unemployment are both neither rising nor falling. That is, it is the interest rate where monetary policy is neither stimulating nor restricting the economy. It is therefore an elegant and potentially helpful concept. After all, it informs investors of what monetary policy is doing and where interest rates may ultimately land when the Fed accomplishes its monetary policy mission.

We have written and spoken about this topic in the past, before it became as mainstream a concept as it is becoming now.

Unfortunately, there are a lot of variables that drive inflation and unemployment in addition to interest rates, and so we have to estimate r* using a bit of guesswork. Further, there is a general view that r* has (or had) fallen over the years. After all, why didn't the aggressive easing of monetary policy in the 2010s lead to runaway inflation? It didn't, and that led economists to believe that r*, the neutral rate at which inflation and unemployment were both stable, had fallen.

However, more recently, economists are thinking that r* may have risen, and this has consequential implications for interest rates, and therefore for bond and stock prices.

In the interests of time, we will reiterate our view that r* never fell as far as economists and the Fed felt (note that the pioneering work on r* was done by John Williams, who runs the New York Fed today). Instead, we believe that r* was and is always higher and more stable than the more fluid estimates. Instead, we believe that the reason that we did not have runaway inflation when interest rates were near 0% was less about r* falling and more about a less-than-expected impact on the economy from moving interest rates down.

We believe this impact is symmetric, and that the implications are significant. After all, if moving interest rates up in order to quell inflation is because the neutral interest rate, r*, is now higher, then that has obvious implications: interest rates will be higher for longer and will come to rest at higher levels when the Fed tames inflation. But, using our views here at Northeast, there is the additional impact because we believe not only is r* higher than expected, but that the Fed must raise its policy rate even higher OVER r*, the neutral rate, than expected in order to tame inflation.

So here is this esoteric concept, r* -- the neutral interest rate --- that no one paid much attention to when the Fed was lowering interest rates and soothing markets during the last decade. But we believe that investors, as witnessed by the Wall Street Journal article, will be paying more attention to the concept as interest rates rise and perhaps stay at elevated levels, pressuring asset prices across the board.

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NORTHEAST INVESTORS TRUST

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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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