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Investment Insights
US interest rate outlook

December 2015

FOR INVESTMENT PROFESSIONALS ONLY

Expect a slower path to higher interest rates.

Summary

- The key question facing US monetary policy is not whether the Federal Reserve will raise interest rates this year or next, but how far it can go given mixed economic conditions in the US and intensifying financial pressures around the world.
- Many are questioning whether the US economy is strong enough to absorb a meaningful rise in rates – even 100 basis points – over the next couple of years, especially against the backdrop of weakness in Europe and emerging markets.
- In the US, low inflation, slowing job growth and a strong dollar are the crucial factors that should prompt the central bank to move slower than market expectations.
- Overall, we expect US interest rates to remain suppressed for the foreseeable future, especially against the backdrop of cautious and measured Federal Reserve policy.

For years, investors have expected interest rates to go up, simply because they have been so low for so long. Now as the Federal Reserve (Fed) prepares to raise short-term rates for the first time since 2006, many of our portfolio managers and economists believe that the central bank will tighten monetary policy at a slow pace and long-term interest rates will remain low.

"The Fed's first move isn't nearly as important as the slope of subsequent rate increases," says fixed income portfolio manger David Hoag. "In my view, that slope has always been shallow. We should expect very slow, measured increases in short-term rates as the Fed seeks to gradually shift policy back toward a more normalised level.

"The message we've heard from the Fed confirms that view," Hoag adds. "The 'lower for longer' interest-rate scenario is still very much intact. Given that backdrop, I am less concerned about the first rate hike and more focused on the second, third, fourth and fifth. I think those have been pushed further out by recent international events, particularly the slowing of China's economy and the financial turmoil resulting from it."

Over the past two years, as Fed officials have repeatedly voiced their desire to raise rates in the near future, the yield on the benchmark 10-year Treasury bond has actually declined by nearly a full percentage point.

Low-rate environment to persist

What are the factors keeping rates low?

- **Underlying signs of weakness** in the US economy. Although the headline numbers – GDP growth of 3.9% in the second quarter and a 5.1% unemployment rate in August – look strong on the surface, other economic indicators appear less so. For instance, the labour force participation rate has fallen to a 38-year low of 62.6%, meaning fewer people are actually working or looking for work. Wage growth and business investment have been lacklustre. And even job growth has fallen below expectations in recent months.

- **A lack of inflation**, largely due to falling energy prices, has removed one of the Fed's primary motivations for raising rates. With oil prices plunging about 50% since the summer of 2014, the threat of inflation has virtually disappeared. The Fed's preferred inflation gauge, the Personal Consumption Expenditures (PCE) Index, has risen just 0.3% over the past year, far below the Fed's 2% inflation target. Stripping out volatile food and energy prices, the PCE Index is still only up 1.3% year over year.

- **A strong US dollar**, largely influenced by global trends, has made it more difficult for the Fed to raise rates because of the dampening effect it has on exports and corporate earnings. During the past year, the dollar has appreciated 14% against a basket of global currencies, reaching a 12-year high in March.

- **Turbulence in global markets** and geopolitical conflicts have at times created a powerful "fear trade", driving investors to seek shelter in US Treasury bonds. With far more buyers than sellers, rates can, and have, remained low. Foreign buying has been particularly strong. Japan and China are among the largest holders of Treasury bonds.

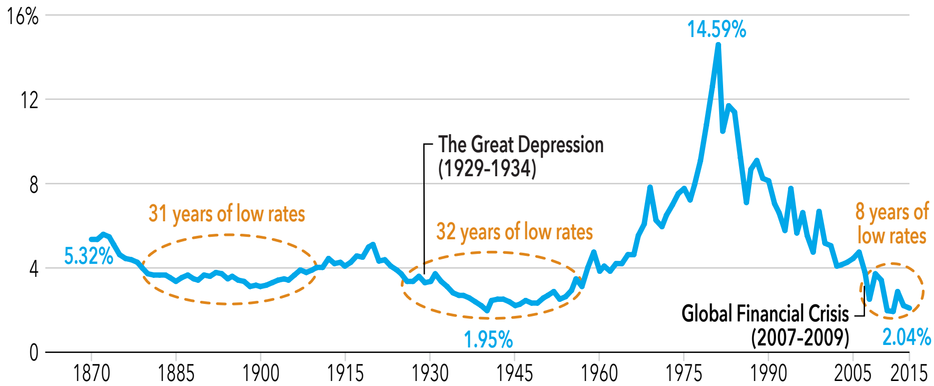
- **Quantitative easing** (QE) has gone global. Although the Fed halted its bond-buying programme in October 2014, the European Central Bank launched an ambitious new QE initiative in March of this year, to the tune of €60 billion a month. The Bank of Japan, meanwhile, has been purchasing ¥6 trillion to ¥8 trillion of government bonds each month. With bond yields in Germany and Japan well below 1%, US Treasury bonds are essentially anchored lower by the weight of international monetary stimulus.

All of these factors played into the Fed's 17 September decision to forego a rate hike, despite sending signals all year that it wanted to make a move soon. Since then, Fed Chair Janet Yellen and other officials have indicated that they expect to raise rates before the end of 2015.

Exhibit 1: Lower for longer

US interest rates have remained low for extended periods at several junctures in US history

10-year Treasury yields



As at 30 September 2015. Source: Thomson Reuters Datastream

Outlook for the US economy

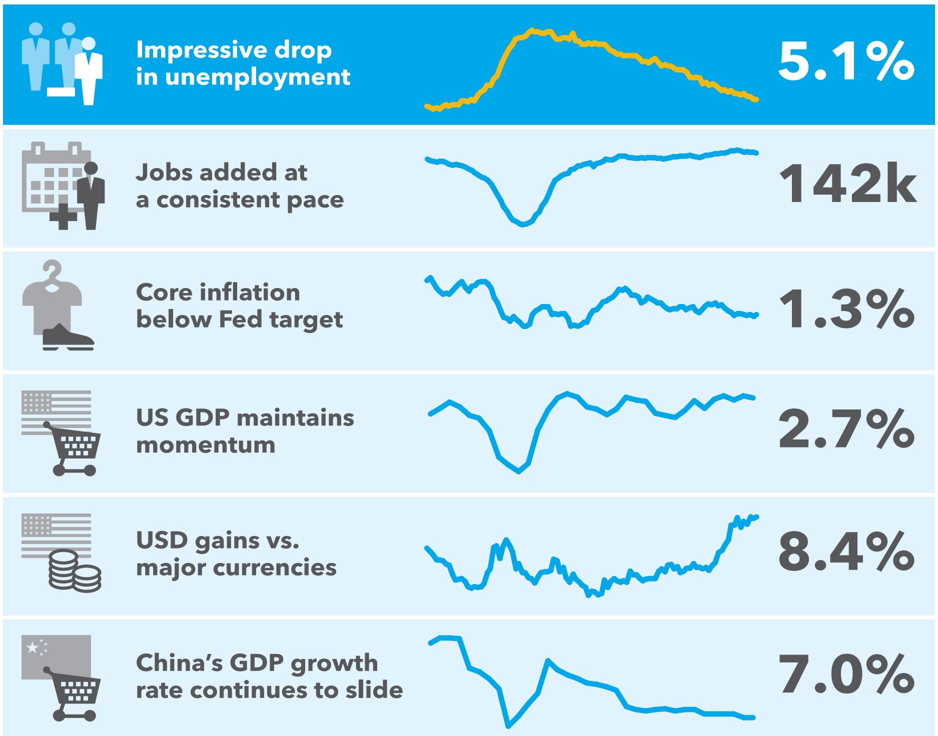
There is no doubt that the US economy remains one of the few bright spots in the world. However, it has not completely recovered. Whenever the economy appears to be reaching so-called escape velocity, something happens to bring it back down to earth – a flare-up in the European debt crisis; across-the-board cuts in US government spending; or, this time around, a global stock market selloff sparked by economic troubles in China and other emerging markets.

"The economy hasn't been bad – it's just been weighed down by one problem after another," says economist Darrell Spence. "The big question right now is, how will all of this weakness around the world affect the United States? So far, the results have been mixed, with falling energy prices offsetting non-US weakness and a stronger dollar. The US economy is uncomfortably balanced between strong domestic growth and a weak international scene."

Some have warned that China's slowing economy will eventually bleed into the US, but Spence is sceptical of that argument. Exports to China account for less than 1% of US GDP and, according to the Commerce Department, less than 20% of profits at public and private companies in the US are generated abroad. "The US economy is still largely dependent on domestic consumption," Spence adds, "so while a hard landing in China wouldn't help, it is entirely possible that we could ride out this volatile period without a serious impact on corporate America."

Exhibit 2: Data dependent: What does the Fed care about?

The Federal Reserve looks at various economic metrics in setting the fed funds rate.



Source: Datastream

US unemployment rate, US job growth and US dollar gain: Period measured covers 1 January 2007 to 30 September 2015. US dollar gain is a weighted average measured against the euro, yen, Canadian dollar, British pound, Swiss franc, Australian dollar and Swedish krona.

Core inflation: Period measured covers 1 January 2007 to 31 August 2015. Core inflation, which excludes volatile food and energy prices, calculated monthly as part of the Personal Consumption Index (PCE).

US and China gross domestic product (GDP): Period measured covers 1 January 2007 to 30 June 2015.

Bond maths

How can investors make money in the bond market when rates are at historically low levels? Be patient and let time work for you.

The following is a hypothetical example. Actual results may vary substantially from this outcome.

August 2014: An investor buys a Treasury note with a maturity of five years and a coupon of 1.625%.

Price	$100.00
Coupon	1.625%
Yield to Maturity	1.625%

August 2015: That 5-year Treasury becomes a 4-year note.

Price	$100.96
Yield to Maturity	1.37%

Coupon	1.625%
Capital gain	+ 0.96%
Total return	**2.58%**

"In an environment where yields go sideways despite expectations of higher rates, the effect of a roll-down pays the patient investor."

Mark Brett
Fixed income portfolio manager

How low for how long?

Ultimately, interest rates will head higher when the Fed decides that the US economy no longer needs the extraordinary support provided by ultra-low borrowing costs. Fed officials have repeatedly said their future decisions will remain "data dependent".

Fergus MacDonald, a fixed income portfolio manager, reminds us that "the Fed's mandate is maximum employment and a 2% average rate of inflation. It is arguably close on its employment goal but still missing its inflation target, with core inflation currently around 1.3%. I would expect the Fed to be very cautious and communicate a very shallow path of future rate increases."

Hence, even after the initial rate increase, US monetary policy will remain extremely accommodative. Rates will still be low by historical standards, and the Fed will still own trillions of dollars of Treasuries and mortgage-backed securities that it purchased during three rounds of quantitative easing. The Fed could sell those securities, as another means of tightening policy, but it has indicated no desire to do so in the near future.

"We should expect US rates to stay relatively low until we get through this current period of uncertainty," says fixed income portfolio manager Wesley Phoa. "We are seven years removed from the Global Financial Crisis, and as it stands now the United States has recovered well. It took a long time, but the US economy has improved. Meanwhile, we need to keep in mind that Europe is still trying to recover from a follow-on crisis, and China is now dealing with its own set of problems."

Rates have stayed low for extended periods at other times in history when they were deemed necessary to recover from financial crises or the high cost of wars. In fact, throughout much of American history going back to 1870, low rates generally have been the norm (see Exhibit 1). It was only during the 1970s and 1980s, when the Fed was attempting to tame high inflation, that rates soared to extremely high levels, with the 10-year Treasury yield climbing above 14% in 1982. Ever since then, 10-year Treasury yields have been in a long-term declining environment, hitting what now appears to be a bottom of 1.43% on 25 July 2012.

"Global financial trends take many years to play out," Phoa says, "and it isn't always easy to tell when they may be resolved. I like to say, 'We will know we are in good shape again when people stop talking about the Fed.'"