RBC WEALTH MANAGEMENT
Global Insight
Focus Article

Misplaced high anxiety over interest rates

Don't let angst about the potential for higher rates cloud the reality that a low rate environment should be with us for some time.

Craig Bishop

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All values in U.S. dollars and priced as of February 28, 2017, market close, unless otherwise noted.

Wealth Management

Focus article

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While the U.S. economy no longer needs the crutch of abnormal, emergency monetary policy, escape velocity remains elusive and will probably be a story for 2018. So with the Fed likely to stay on its patient track, investors shouldn't be overcome with angst over higher interest rates and instead be on the lookout for selective buying opportunities in bonds.

Solid economic fundamentals have underpinned a rally in equities and a rise in bond yields since the end of summer in 2016. Equity markets continue to power to new highs, but surprisingly bond yields have remained range-bound despite a hawkish tone from the Federal Reserve and a steady stream of solid economic data. Whether due to uncertainty about the size and timing of fiscal stimulus and deregulation or the recognition that for now this could be as good as it gets for the economy, our view is that the bond market is signaling a continuation of the current low rate environment in which ongoing volatility will provide selective buying opportunities.

Interest rates: Long live the bull

We believe, to paraphrase Mark Twain, the reports of the death of the bond bull market have been greatly exaggerated.

Interest rates bottomed in July 2016 and began to move higher late last summer, prior to the election. The yield on the 10-year Treasury note peaked at 2.60% in December, but since then has settled into a trading range of roughly 2.30%–2.50% despite suffering body blows from the aforementioned solid economic data and the Fed's hawkish leanings. The Fed's 2.0% inflation target, rather than a trigger to higher levels, could actually act more as a cap on longer rates. Furthermore, the impact from slow global growth and accommodative central banks suggests to us rates will struggle to move materially higher in the near term, and could even test lower levels.

A long-term (140 years) chart of 10-year yield patterns indicates that the 3.0% level (last touched in December 2013) would need to be significantly broken in order for the lower trend of the past 30 years to change. Until then, the overall longer-term trend continues to be down, so long live the bull.

As good as it gets, for now

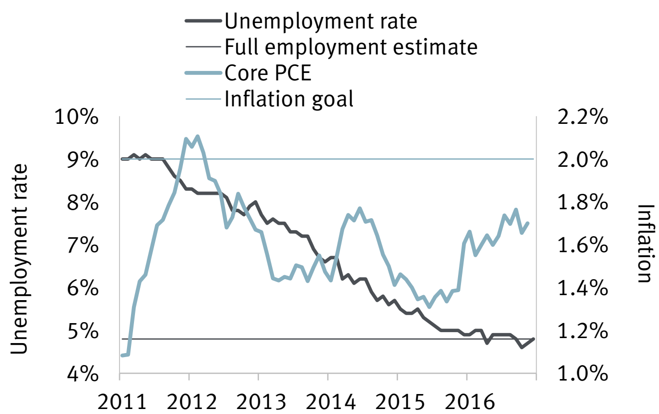
In their book *This Time Is Different: Eight Centuries of Financial Folly*, Carmen M. Reinhart and Kenneth S. Rogoff made the case that financial crises which emanate in the financial sector can pose greater and lengthier recovery challenges for economies. The Great Recession ended in 2009, but signs of a sustainable recovery have proved fleeting, until now, a long eight years later.

Misplaced high anxiety

Since 2010, U.S. GDP growth has averaged 1.9%, certainly far from levels of past recoveries and nowhere near what is often thought to be "breakaway" levels of 3% or better. Improving fundamentals suggest that possibly, for the first time since 2005, 3% annual growth may be in sight, but, according to RBC Capital Markets, this will be a 2018 story with 2.5% GDP growth forecast for 2017.

At this juncture, we remain focused on fundamentals. Our recessionary scorecard focuses on key segments of the economy—the yield curve, manufacturing activity, housing activity, as well as inflation and employment trends. The current message is "all clear" with no recession in sight, but breakaway speed will remain elusive for now, in our opinion.

Dual mandate: Mission (almost) accomplished



Full employment is in sight; the Fed's inflation target remains elusive.

Source - RBC Wealth Management, Bloomberg; Data through 2/17/17

Our recessionary scorecard is currently signaling "all clear" for the U.S. economy.

The Fed tilts hawkish

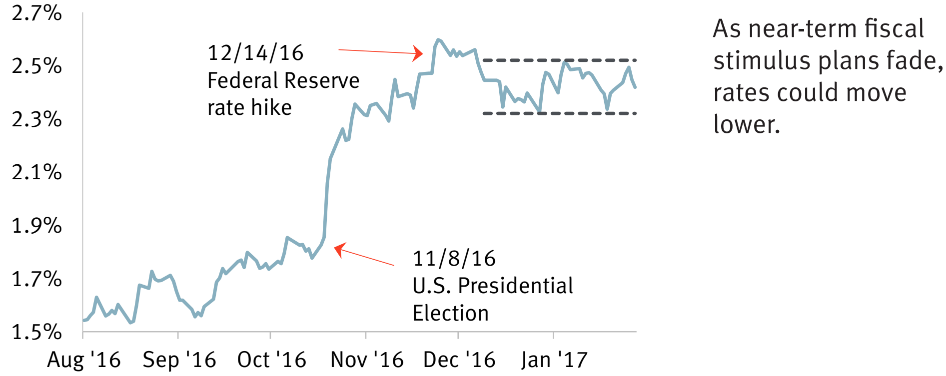
The improving economic fundamentals and, specifically, the dual mandate of full employment and stable inflation have led Chair Janet Yellen and Fed policymakers to adopt a more-hawkish stance for the first time in several years.

Unemployment has recently been flirting with "full employment levels," hitting 4.6% in November and recently settling around 4.8%–5.0% as more confident job seekers, encouraged by rising wages, re-enter the labor force. Stable oil prices have put the Fed's 2% inflation target within reach. The Consumer Price Index reported an annual rate of 2.5% for January, but the Fed's favored inflation barometer—core PCE (personal consumption expenditures)—has some room to go, sitting right now at 1.7%.

This near "mission accomplished" on inflation and employment has put some teeth in the Fed's continued guidance that "every meeting is live" for a possible rate hike. Even though rate hike probabilities for the March meeting sit at just above 80%, we think policymakers will want to wait for more data before proceeding with the next move. Given their proclivity to make policy changes at quarterly meetings, when they provide revised forecasts and Yellen holds a press conference, we think the next hike will occur in June. The minutes from the February meeting, the first with a new slate of more dovish voters also suggested, in our opinion, a willingness to exercise continued patience.

Home on the range for 10Y yields

U.S. Treasury 10Y yield



Source - RBC Wealth Management, Bloomberg; Data through 2/17/17

Rates will remain range-bound even with a hawkish Fed due to low inflation and slow growth.

In our view, the key statement from Yellen's recent semiannual report to Congress on monetary policy was that the Fed will only raise rates in response to faster growth "if it threatens our inflation objective." To us, this suggests a strong domestic focus from the Fed with decisions still driven by the data.

Improving fundamentals put the U.S. economy on a path to being able to stand on its own without the support of extraordinary monetary policy accommodation, but, in our opinion, not enough yet to move the Fed off its patient, gradual approach to policy normalization. For now, we think this means two rate hikes, rather than the three forecast by the Fed's "dot plot" (which captures the Fed's internal forecasts for the path of future rate hikes), is the probable path for 2017.

Maintain a focus on fundamentals *not* potential

Since the election, the potential benefits of fiscal stimulus measures, including tax reform, deregulation, repatriation of overseas assets, and infrastructure have been widely anticipated and have been significant market drivers. However, "potential" has met "political reality" in Washington; the focus has shifted and the timing of implementation has been pushed back. Tax reform and deregulation appear to be priorities, but infrastructure spending less so with policies not likely to be enacted until later in 2017, if not 2018 or beyond.

At some point, the economy could receive a solid boost from these "potential" issues, but for now investors should be more focused on the underlying fundamentals which should keep the economy growing at a slow and steady pace in a continued low interest rate environment. So while market volatility will remain high, investors shouldn't be overly concerned or fixated on higher interest rates to the point they miss selective opportunities in the credit markets.

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