Rising Rates: Not So Fast

October 15, 2018

by Tony Crescenzi

of PIMCO

Worries about rising U.S. interest rates have gripped global financial markets in recent weeks, with investors questioning whether the era of historically low global interest rates will persist.

Our view: Yes, it will. Despite the latest uptick in rates, we believe our New Neutral thesis – which holds that economic and demographic factors will weigh down equilibrium interest rates – remains the appropriate framework for valuing fixed income assets.

Policy rates are likely to stay lowest in Europe and Japan, with the European Central Bank and the Bank of Japan likely to keep their rates around zero for at least several more years.

As for the U.S., we believe a tight labor market will compel the Federal Reserve to stay on a gradual rate-hike course, placing continued upward pressure on market interest rates. Nonetheless, much of this story has already been written, and there is limited scope for rates to rise significantly further owing to a variety of potent factors.

Decision point

All of that said, global bond investors are near a "decision point" on whether the Fed will end its rate-hike cycle when the federal funds rate nears 2.875%. For about three years, the bond market has viewed this level as the terminal rate, implying an increase of about 75 basis points from today's rate. Accordingly, for Treasury yields to move meaningfully from current levels, investors would have to expect either a higher or lower terminal rate for federal funds.

This decision point is why somewhat higher rates are plausible. Investors may have confidence in the Federal Reserve's projection that its policy rate will peak at 3.4%, leading the Fed to push Treasury yields up to that level or a bit higher. Moreover, as we mentioned in our March outlook, "The Beginning of the End?" the neutral policy rate is an anchor and not a floor or a ceiling.

Nonetheless, in our most recent *Cyclical Outlook*, "Growing, But Slowing," we project the Fed will increase its policy rate to a range of between 2.75% to 3.00% by the end of 2019, a benign outcome. We believe the anchors to The New Neutral framework remain firmly in place, in particular, demographic influences such as the aging of the Baby Boomers, which will impair U.S. growth potential into the 2030s. Also at play are slow increases in investment and infrastructure spending, two

©2018 Advisor Perspectives, Inc. All rights reserved.

major negatives for productivity growth. Rounding out the argument is the slower-than-historical pace of credit creation, a high global savings rate, and cautious consumer spending.

Broader market implications

Investors confused by the combination of falling equity and bond prices should consider many of the late-cycle dynamics – as discussed by Mihir Worah, CIO Asset Allocation, in “Late-Cycle Investing” – that can affect their portfolios, and weigh increasing their focus on risk factors such as equities, interest rates, volatility, and liquidity, building portfolios from the bottom up rather than seeking pure equity and credit beta.

In sum, while many factors can presage a bull-market-ending economic recession, high global interest rates are not likely among them. Yet for economies that today are inherently fragile, any tilt away from the extraordinary low-rate era can prompt quakes now and then.

Tony Crescenzi is a market strategist, portfolio manager and contributor to the PIMCO Blog.

All investments contain risk and may lose value. This material is intended for informational purposes only. Forecasts, estimates and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America L.P. in the United States and throughout the world. THE NEW NEUTRAL is a trademark of Pacific Investment Management Company LCC in the United States and throughout the world.

©2018, PIMCO