Efficient Markets at Work

By Editor Test *Wed, Jun 2, 2010*

Ken Volpert, a principal who runs the $500 billion taxable bond group at Vanguard, is unruffled about interest rates. A sharp rise in intermediate and long-term rates isn't likely, he says. The economy is weak and the bond market has already priced in a potential rate hike by the Fed. "The rates are already there," ... Read more »

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"The rates are already there," Volpert told RIJ, noting that futures contracts reflect a Fed Funds rate of 2%, compared to today's target Fed Funds rate of zero to 0.25%. "Normally the spread between two-year and 10-year Treasuries is 100 basis points; today it's 280 basis points," he said.

"The increase is already priced in. Intermediate and long-term bonds are already paying the rates that the market thinks they will be after a rate hike. The question is, what will actually happen versus market expectations? We don't think they'll raise rates as fast as the market is pricing in right now."

An inflation scare could theoretically trigger a sharp rise in long-term rates, he said, but he sees little chance of inflation as long as the U.S. economy remains sluggish. "There is so much slack in the economy. Global deflationary forces are very powerful," Volpert said.

As the Fed reduces its balance sheet by selling the debt it bought from troubled banks, it will absorb cash from the economy and slow it down, he believes. If the banks started lending the $1.2 trillion they have on reserve at the Fed, it would be inflationary; but they aren't—because loan demand is low and because the Fed, for the first time, is paying interest on those reserves.

At the moment, Volpert is over-weighting corporate bonds and asset-backed securities. Vanguard, characteristically, is advising its retail bond fund investors to stay diversified and not concentrate their money in short-term bonds, because short-term rates are likely to move much more than long-term rates.

"We're not looking at a crisis," he said. "We're very much on hold. You want to be in intermediate bonds. We think rates will rise less than the markets believe." For more of Vanguard's views, see *Deficits, the Fed, and rising interest rates: Implications and considerations for bond investors,* from the Vanguard Center for Retirement Research.

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