Waiting on the Fed

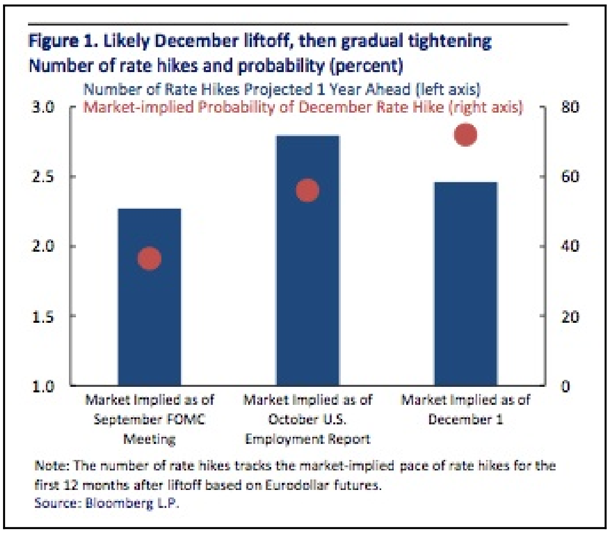
By Kerry Pechter *Thu, Dec 10, 2015*

'The long end of the curve will stay stable but the front end of the curve will go up, so that we'll have eventually have 2.5% at the short end and a long end between 2.5% and 3%,' predicted a BNP Paribas managing director recently. (Pictured: Janet Yellen.)

Barring a sudden sell-off on Wall Street, higher short-term interest rates are coming soon. But don't expect more than a tiny hike. And don't expect long-term rates to budge. That kink in the life insurance industry's air hose isn't going away soon.

According to the Treasury Department's own Office of Financial Research, movements in foreign equity and fixed income markets imply a 75% chance of a 25-basis point increase in the Fed Funds rate (currently about 0.12%) at the Fed's December 15-16 meeting. The perceived likelihood of a hike was 40% after the September Fed meeting and 60% after the October meeting.

Because emerging markets are sensitive to U.S. interest rates and exchange rates, their movements can indicate expectations of changes in those rates. Since early November, broad emerging market equity indexes have fallen about 3%, sovereign and corporate bond spreads have widened by 20-to-30 basis points, and oil-linked currencies have depreciated by between 4% and 8%, said the OFR report. Mutual fund investors have resumed selling emerging market equities and bonds.



While there's now a consensus that the Janet Yellen-led Fed will make a cautious move next week, a return to historically "normal" interest rates in the foreseeable future is not predicted. (In point of fact, there may be no normal rate. As this St. Louis Fed [chart](#) shows, rates trended generally up from 0.83% in 1954 to 19.10 in 1981, and then generally back down to 0.12% last month, with intermittent spikes before recessions.)

Any inclination toward higher rates is expected to be "very gradual." "Recent Fed communications also focused on the path of policy following liftoff and reinforced expectations for a gradual pace of rate increases over the next year. The market is currently pricing in two-to-three 25 basis point rate hikes in the 12 months after the first increase," said the OFR report.

So much for short-term rates. But what about yields on 10-year Treasury bonds, which give insurance companies fuel for income annuity payout rates and variable annuity hedging strategies? Philippe Combescot, managing director, Global Equity and Commodity Derivatives, BNP Paribas, predicted recently that the yield curve in the near future will be flat, with long-term rates not moving much in response to several small hikes in short-term rates.

"Our prediction is that the long end of the curve will stay stable but the front end of the curve will go up, so that we'll have eventually have 2.5% at the short end and a long end between 2.5% and 3%," Combescot said in a presentation at the Society of Actuaries EBIG (Equity-Based Insurance Guarantees) Conference in Chicago last month.

"Some analysts are saying that the period of low rates might stay for longer than we thought, and as long as globalization keeps a lid on wages, that situation could remain for a long time In Japan, they've had one-percent rates on 20-year bonds for 25 years," he added, noting that the Fed might decide to raise short-term rates to 1.5% and stop there for awhile.

Year End Forecasts for USD Treasury Rates

	Spot	BNP forecast End 2015	BNP forecast End 2016	BNP forecast End 2017
Fed Funds Target	0-0.25%	0.25-0.5%	1.5-1.75%	2.5%
Fed Funds O/N	0.13%	0.25%	1.5%	2.5%
2Y	0.63%	1.0%	2.0%	2.5%
5Y	1.38%	1.6%	2.25%	2.55%
10Y	2.1%	2.15%	2.5%	2.65%
30Y	2.93%	2.9%	3.0%	2.85%

Long-term rates will stay low because investors are "more worried about low inflation outcomes than high inflation outcomes," Combescot said. He noted that the 10-year Treasury prices have produced a negative yield for the past three years, but that investors pay those prices on the chance that a future flight to Treasuries might drive prices even higher. "Investors and some economists are pricing in a 25% chance of recession. The Fed is not," he added.

“When the Fed raised rates in 1994, the GDP growth rate was 5%. Today we are talking about something closer to 2%,” he said. “Financial conditions have tightened and that has done most of the work that the Fed is supposed to do. Zero [short-term interest rates] may not be far from where it should be.”

The equity markets are pricing in a “very benign” hiking cycle, because the sluggishness of the economy and the lack of inflation doesn’t warrant anything more. Historically, the stock market has fallen 10.5% on average in response to every one percent increase in interest rates. according to W. Michael Cox, director of Southern Methodist University’s O’Neil Center for Global Markets and Freedom.

Cox told advisors at the IMCA 2015 Winter Institute Conference on Retirement and Decumulation in Phoenix last week that, there’s been a significant sell-off in stocks within three to six months of the beginning a hiking cycle. He blamed the current high valuation of the stock market on the Fed’s “methamphetamine” interest rate policy.

Not everyone believes the Fed dictates interest rates today. Also speaking at the IMCA retirement conference, Michael Finke of Texas Tech argued that the aging-related global savings glut has pumped up demand for, and prices of, both stocks and bonds. The supply of bonds has actually risen, Finke said, but the demand for bonds has risen even more, driving high bond prices and low yields.

Historically, low current bond yields presage low future total bond returns, Finke said, and high CAPE ratios (or Shiller ratios) presage low equity returns. When the CAPE or Shiller ratio is high—yesterday it was 25.88—future 10-year annualized equity returns have been about 6%, he said. The future will be characterized by below average returns on financial assets, which Finke believes will make the supposedly “safe” withdrawal rate of 4% per year from savings during retirement too aggressive.