GWI Insights: The long and short of interest rates

**Jack Brown, CFA**
Senior Vice President, Separate Accounts,
Great-West Investments™

**Daniel Gargan**
Client Portfolio Manager,
Great-West Investments™

Earlier this week, the 10-year U.S. Treasury breached 3% for the first time since 2013. Much has been made regarding the implications of surpassing this threshold, especially from a market psychology standpoint. From a fundamental perspective, and this has been our view from the start of the year, the upward movement in rates is warranted as inflation has been moving higher from a variety of different metrics.

Core inflation has been rising and is at sufficient levels to warrant additional rate hikes by the Federal Open Market Committee (FOMC), especially considering the strong labor market. As of March 31, 2018, the core Consumer Price Index (CPI) sits at 2.1% while the Personal Consumption Expenditure (PCE) deflator sits at 1.8%. Food, energy and other commodities have also seen their prices increase significantly in recent times. On Q1 earnings calls, many companies have cited higher inflation and input costs and the subsequent impacts of these factors on their bottom lines.
While the market’s attention has been focused on 10-year yields, we have to recognize that 3% is not much different than 3.25% or 2.75% for the broader U.S. economy. In fact, historical 10-year yields have been much higher than 3% during many expansionary periods in the past and, adjusting for inflation, real 10-year yields remain fairly low. However, there is a part of the U.S. yield curve that can, and will, impact the economy and that is on the short end, so that is where we are really paying attention. Movements on the front end have a much more significant and immediate impact on day-to-day activities in capital markets. The FOMC continues to raise the Federal Funds Rate, the London Interbank Offered Rate (LIBOR) has been steadily rising, and the two-year Treasury rate hit 2.5% this week, the highest in 10 years.

Source: Bureau of Labor Statistics

Source: Bloomberg
Rising yields on the short end of the curve impact anything from autos, credit cards and bank loans to floating rate mortgages. Rising short rates impact real purchasing power to both businesses and consumers as they translate more rapidly into real economic activity.

Given that we are 36 quarters into the second-biggest business cycle in market history, swiftly rising yields are a signal of growing market pressures. While a steep rise in short rates does not necessarily indicate a recession is around the corner, it has become a highlighted area of focus for us and all other market participants. From a historical perspective, an inverted yield curve (where short rates are higher than longer rates) has been associated with the later stages of business cycles and has preceded multiple recessions. While the yield curve is not inverted today, we expect such an inversion to occur sometime in the future. The Fed has indicated that their own projections on the forward path of rates predict the yield curve will invert in 2020.

It is our view that rates are rising for the right reasons and are a function of a strong domestic economy. The labor market is robust, consumption is healthy, business spending has picked up and, while undersupplied, the housing market remains on solid ground. Treasury yields fell after the start of the year following concerns of tariffs and trade spats, and we believe the recent rise in rates is at least in part a function of these concerns being alleviated. We believe this business cycle has more room to run given the strong economic backdrop, but we feel it is important to be cognizant of where we are at in the cycle so we can position our portfolios accordingly.