# Will Interest Rates Move Higher?

The last bear market in bonds began in the middle of the last century and lasted for about 31 years. Some investors who bought bonds in 1950 locked in relatively low rates of return for a very long time. On January 1, 1950, 10-year U.S. Treasury bonds yielded 2.3 percent.[1] As interest rates moved higher, the market value of those bonds diminished.

The good news was people could hold bonds to maturity and expect to receive a return of principal. The bad news was they missed an opportunity to earn higher returns in the meantime. By early 1960, when a 10-year Treasury bond would have matured, rates on newly-issued 10-year Treasury bonds had more than doubled to 4.7 percent.[1]

The current bull market in bonds began in the early 1980s. On January 1, 1982, the yield on a 10-year U.S. Treasury bond was 14.6 percent.[1] Since then, yields have dropped. In early December 2017, a 10-year Treasury returned about 2.4 percent.[2]

Treasury bonds have offered relatively low rates of return for almost a decade. For the last several years, analysts have been predicting the current bull market in bonds will end. In fact, *Financial Times* recently commented that forecasts for 2018 seemed awfully familiar:[3]

> "The median analyst forecast is for the Fed's favored inflation measure to quicken from 1.5 percent to 2 percent by 2019, the 10-year Treasury yield to climb to almost 3 percent by the end of 2018, and the S&P 500 to gain another 7 percent to hit 2,825 points…The problem is that this is, in broad terms, what most analysts have wrongly been predicting for years. Year after year, inflation has stayed stubbornly well-behaved, the Fed has tiptoed forward, and bonds have repeatedly defied the naysayers."

**Monetary policy will make a difference**
In 2008, following the global financial crisis, the U.S. Federal Reserve reduced the fed funds rate, which is its overnight lending rate, to nearly zero. When it became apparent low rates weren't enough to restore our country's economic health, the Fed engaged in several rounds of quantitative easing (QE).[4]

QE entailed purchasing billions of dollars of Treasury bonds along with mortgage-backed and U.S. agency securities. QE created the demand to keep interest rates low and encouraged banks to lend so entrepreneurs would have the money needed to build new companies and established businesses would have the capital to grow. By the time the last round of QE ended, the Fed's balance sheet had more than quadrupled. The Fed owns a lot of bonds.[4]

Already, the Federal Reserve has begun taking steps to 'normalize' monetary policy. The *St. Louis Federal Reserve Bank* explained monetary policy normalization includes three elements:[5]

1. **Gradually increasing short-term market interest rates.** The Federal Open Market Committee increased rates for the first time in December 2015.[4]
2. **Reducing the size of the Fed's balance sheet.** This began in late 2017. The Fed has not been rolling over all of the Treasury and mortgage-backed securities in its portfolio at maturity. This reduces demand for Treasuries and should help push yields higher.[6]
3. **Transform the Fed's current portfolio.** This is so it resembles the Fed's pre-Great Recession portfolio, which held mostly shorter maturity Treasuries.[5]

The Fed led the world in monetary policy stimulus, and it is the first central bank to begin normalizing its monetary policy. It isn't the only one. The European Central Bank will begin to reduce its QE program by cutting its monthly bond purchases in half, and the Bank of Japan is under pressure to reduce stimulus efforts. *BloombergView* commented, "With the ongoing synchronized pick-up in global growth, systemically important central banks will likely be more willing and able in 2018 to start and, in one case continue, the normalization of monetary policy."[7]

**What will higher interest rates mean for investors?**
When central banks begin to push rates higher, the cost of borrowing also goes up. Higher borrowing costs mean individuals will pay higher interest rates on credit card debt and loans, governments will payer higher interest rates on outstanding debt, and corporations will pay more to borrow money to run or expand their businesses.[8]

Higher interest rates will also make bonds more attractive than they have been for a number of years because investors will earn more interest when they invest in bonds. Generally, investing in bonds means an individual is agreeing to lend his or her money to a corporation or government for a specific period of time. At the end of that time, the investor expects the principal amount to be repaid.[8]

Sometimes, rising interest rates will make stocks less attractive to investors. During the past decade, when bond rates were generally very low, some investors purchased dividend-paying stocks to boost their incomes. If they can earn a similar income by investing in bonds that have lower risk, they may choose to do that. However, it's important to recognize bonds don't have the potential to provide capital gains as stocks do.[8]

If you have any questions about the ways higher interest rates may affect your portfolio, please contact us to speak with your financial professional.

Sources:
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