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With the end of quantitative easing, the U.S. enters era of gradually rising interest rates

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Executive summary

- The Federal Reserve is likely to move slowly as it increases short-term interest rates, with smaller moves than in previous cycles.
- Treasury yields are likely to move modestly higher, though by a lesser amount for long-dated securities.
- The U.S. dollar has strengthened. Despite a positive structural story, we do not believe the dollar will return to the highs witnessed in previous rallies during the 1980s and 1990s.
- Inflation rates are low and likely to stay low for a significant time into the future.
- We believe this transition may boost investor confidence, even if it is accompanied by modestly higher market volatility.

With the Federal Reserve's move to end its quantitative easing program in October, the U.S. entered a new era of interest rate policy. The Fed is now in a "normalizing" mode, and will likely end its policy of zero short-term interest rates sometime in 2015, as the economy gains strength and the unemployment rate drops further.

Much apprehension has accompanied this transition, given historically low yields for Treasury securities of all maturities. However, this doesn't necessarily mean that global forces keeping rates low will reverse course as the Fed adjusts its policies. Global growth trends, central bank policies, changing demographics and a lack of global leadership are likely to affect fixed-income markets in the future, with certain sectors benefiting and others likely to be disadvantaged.

While we expect the transition toward an environment of higher interest rates will generate heightened market volatility, this is not necessarily a bad thing. We see market confidence in the economic operating environment rising as the transition takes place.

The post-QE environment

In the post-quantitative easing environment, we believe it is most likely that the Fed will move very slowly to push short-term rates higher, that the size of rate increases will be smaller than in previous tightening cycles, and that the Fed will be mindful of the economy's ability to adjust to that shift. Because inflation rates domestically and overseas are currently low, there is no particular hurry for the Fed to raise rates. Furthermore, wages have shown no sign of rising, and the downward trend in growth rates outside the U.S. means the economy will not benefit from stronger activity overseas anytime soon.

Even though there is no pressing reason for the Fed to act, we believe it will act anyway, for several reasons. The U.S. economic recovery, although subdued, has been generally steady. Policy makers at the Fed want to show that it is taking a methodical approach to interest rate policy, that its policies include an element of discipline and that such a move will signal that economic conditions are normalizing in the U.S. after the financial crisis of 2008/2009. In addition, lifting benchmark short-term rates above zero will improve the functioning of money markets.

Rate forecasts come down

Slower-than-expected growth in the U.S. this year has led to a reduction in forecasts for future Treasury yields.

With a rate hike coming in mid-to-late 2015, we believe that both short-term and long-term rates will rise by the end of the year and keep rising into 2015, though at a slow rate due to the lack of inflationary pressure. Slower-than-expected growth in the U.S. so far this year has led to a reduction in forecasts for future Treasury yields. Ours can be found in Exhibit 1 below.

Exhibit 1: TIAA-CREF Treasury yield forecasts

	2-Year	5-Year	10-Year	30-Year
12/31/2014	0.60%	1.70%	2.50%	3.25%
12/31/2015	0.90%	2.00%	2.75%	3.40%

Please note, the forecasts above concern asset classes only, and do not reflect the experience of any product or service offered by TIAA-CREF. These forecasts are for informational purposes only and should not be considered investment advice or constitute a recommendation to purchase or sell securities. Market forecasts are subject to uncertainty and may change based on varying market conditions, political and economic developments. Past performance is not an indicator of future results.

Weakening growth overseas is pushing down yields for government bonds in Europe and Japan. And while U.S. Treasury yields are low on an absolute level, they are pretty attractive on a relative basis. That will likely support demand for long-dated Treasuries strong from fund managers and central banks around the world, and limit significant rate rises in this part of the curve. As a result, we expect the yield curve to stay in its current “flat” condition and possibly become even flatter. Also, we believe the greater risk to our interest rate forecast is to the downside rather than the upside.

Strong demand for Treasuries and the transition to a rising-rate environment have boosted the U.S. dollar to a four-year high against other major currencies, which can be a headwind to both growth and inflation. While we expect to see the U.S. dollar stay strong in the year ahead, we do not expect it to keep gaining strength rapidly or to match the levels witnessed in previous rallies in the 1980s and 1990s.

Inflation likely to stay low

Historically low inflation rates mean the Fed will likely face little pressure to raise interest rates quickly.

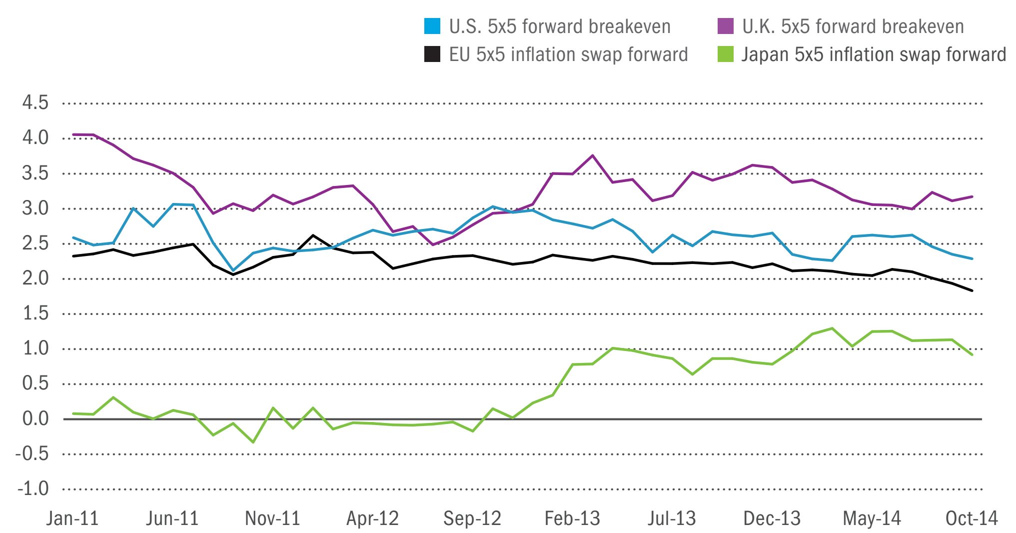
One theme common to the U.S., European and Japanese economies is that inflation rates are historically low and unlikely to quicken in the foreseeable future (Exhibit 2). To gauge future inflation rates, the Fed and other central banks look at the "5x5" measure of inflation expectations, which show what the five-year average inflation rate is expected to be five years from now. In all countries, these expectations are low and/or trending lower, with those in the Eurozone dipping below the 2% mark signaling the potential for disinflation. This means the Fed will face little pressure to raise interest rates quickly unless wage inflation reappears, which we believe is a ways off.

In estimating future inflation rates, the Fed is most closely focused on the rate of wage growth, which has been close to zero since the end of the financial crisis in 2009. Without wage growth, it is very unlikely that inflation can strengthen enough to threaten the economy, so any sign of rising wages will probably have a noticeable impact on market rates as well as Fed policy.

The most recent change to global macroeconomic conditions has been a significant downward shift in growth forecasts for the world's major economies, including China, Japan and Europe, as well as important emerging markets like Brazil and Russia. With activity cooling in these important markets, inflationary pressures will probably stay subdued. The lack of growth and deflationary environments in Europe, many important emerging markets, as well as Japan, are likely to make the Fed more wary of raising interest rates quickly, as the U.S. economy is exposed to declining demand from abroad and a stronger dollar makes imports cheaper.

It is important to note that we are not long-term pessimists or inclined to believe that inflation cannot accelerate under any conceivable economic scenario. In fact, we think that changes in the labor market, positive effects of monetary easing by the European Central Bank, China's restructuring of its domestic economy, along with more people retiring from the workforce, could result in wage growth in coming years. For now, however, that outcome is a fairly distant prospect.

Exhibit 2: Global long-term inflation expectations



The "5x5" forward rates represent the expected inflation over a five-year period, starting five years from now.
Source: Bloomberg

Headwinds for growth and inflation

In its future interest rate policy deliberations, the Fed will take into consideration a number of important secular and structural forces from around the world that will create both headwinds and tailwinds for markets and growth rates.

Among the headwinds to U.S. growth, the end of quantitative easing means the amount of monetary stimulus being added to the economy will decline. This comes at the same time that fiscal stimulus is on the decline as well, with the U.S. fiscal budget deficit now less than 3% of gross domestic product compared with more than 6% as recently as 2012. Meanwhile, growth in consumer and government spending has slowed around the world since 2009.

Regulatory changes to the banking sector in the U.S. and Europe — adopted following the financial crisis to provide increased stability — are also hampering credit growth, delaying recovery and putting downward pressure on interest rates and growth.

A rising dollar is a headwind for growth and inflation as well. By reducing the prices of imported goods, a strong U.S. dollar can be a deflationary force in the economy and can also slow growth by raising the cost of U.S. goods overseas.

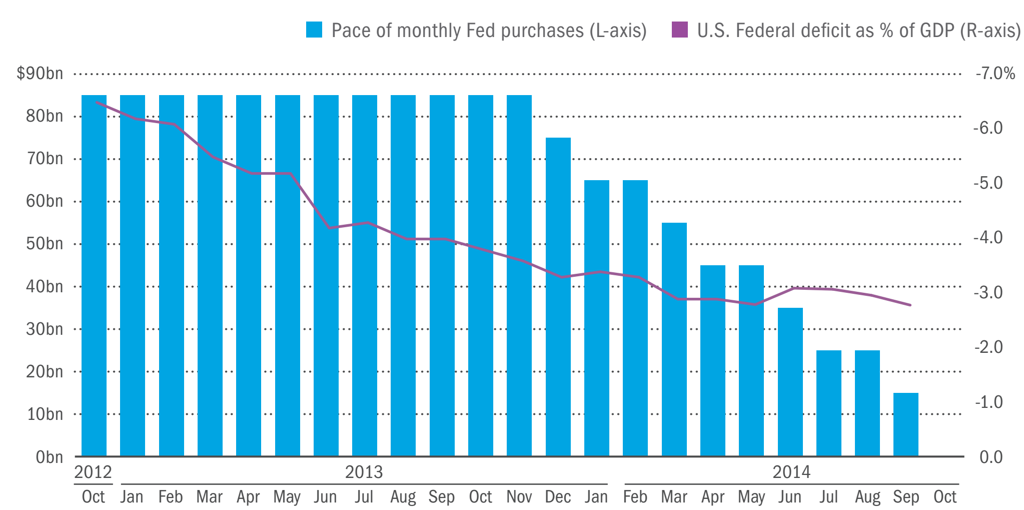
In China, the state-driven growth model focused on exports and investment is giving way to a new, more sustainable model focused on domestic employment and income growth. This will likely mean growth will keep slowing in China, creating a strong headwind for global growth and inflation and undercutting already weak commodity prices.

Tailwinds for fixed income

The Fed's $4 trillion balance sheet will keep downward pressure on long-term interest rates, encouraging faster economic growth.

There are important tailwinds as well, the most prominent of which is the Fed's $4 trillion balance sheet, which is likely to be a factor influencing the U.S. economy possibly for a generation. While the Fed may not be buying $85 billion worth of government and mortgage-backed bonds every month as it did in its third quantitative easing program, it still owns those bonds and plans to reinvest the cash they produce for an indefinite period into the future (Exhibit 3). That will keep downward pressure on long-term interest rates, helping to encourage faster growth.

Exhibit 3: QE ends: The Fed's balance sheet provides a tailwind



Source: Bloomberg

Demographic trends are also providing a tailwind for fixed-income investments globally. With the workforce aging rapidly around the world, even in China, more people will be exiting the workforce in coming years, and they are likely to use fixed-income investments to provide income during retirement.

In addition, a global leadership vacuum has emerged since the financial crisis, with the U.S. and other countries turning inward to manage domestic problems and passing up opportunities to form external alliances. The world's central banks have been forced to fill the deficit in global leadership, using monetary stimulus to dampen market volatility.

Winners and losers

Bond sectors with a "buffer" of yield spread over Treasuries are among those we believe will perform best.

Of course, the gradual transition to a rising-rate environment will create both winners and losers among the market's different asset classes (Exhibit 4). Among those that we believe will perform best are fixed-income sectors with a "buffer" of yield spread over similar Treasuries. For short-term assets, we favor short-term structured products such as mortgage-backed and asset-backed securities. Also at the short-end, we are positive on legacy issues of commercial mortgage-backed securities, which have comparatively high yields. Faster growth will mean more demand for commercial real estate, supporting the sector's fundamentals, as will the declining number of these securities outstanding.

Exhibit 4: Winners and losers in a rising interest rate environment

Sectors most likely to benefit	Sectors likely to be disadvantaged
High-quality high yield (BB-rated)	Deep high yield (CCC-rated)
Short-term structured assets (domestic)	European sovereigns
High-grade corporates	Municipals
Fast-growing frontier markets	Emerging markets lacking reforms
Commodity importers	Commodity exporters

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Long-term assets we believe will perform well include high-grade corporate bonds, which offer enough yield to offset the impact of rising short-term rates. Investment-grade corporate bonds have typically served as a modest buffer in a rising rate environment, with their spread over Treasuries narrowing as rates rise. We are perhaps most positive on "high-quality high-yield," or securities with ratings near the "BB" credit rating level. A stronger economy will help issuers meet their debt obligations, and they provide enough yield to help offset higher Treasury yields.

Fixed-income sectors that we believe are likely to underperform in the new environment include "deep high yield," or debt with ratings in the "CCC" region. We believe these securities are currently overpriced due to strong demand from investors reaching for yield, and that while they do have a place in most portfolios, there will be better opportunities to initiate positions in the future.

Municipal bonds are potential underperformers. After a two-year rally, muni bonds are no longer cheap, and historically they have been susceptible to rising interest rates. Certain emerging-market debt will likely struggle as well, as commodity exporters will suffer from the downward pressure on commodity prices. Lastly, European sovereign and high-quality U.S. agency debt have benefitted from a perception of “safe haven” status, but that will become less important as the U.S. economy gains strength.

Volatility — a positive sign for growth

We view more volatility in rates and markets as a potential opportunity for tactical trading.

As the transition to a rising interest rate environment unfolds, it seems likely that market volatility will increase. In past years, volatility has been compressed by central bank stimulus programs that are flooding markets with cash, while economic risk in the form of unsustainable debt burdens, particularly in Europe and China, have been growing. Going forward, we view more volatility in rates and markets as a potential opportunity for tactical trading, rather than an obstacle.

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