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2005/2006 Interest Rate Outlook

By Jeffrey Irish

As of this writing, the benchmark 10-year Treasury note yields 4.22%. We expect the Federal Reserve to continue raising the short-term, Fed Funds Rate, currently standing at 2.00%, by quarter point clicks through 2005 and into early 2006 until they reach what is called a "neutral" rate. A neutral Fed Funds Rate, one that neither boosts nor hinders the economy, is generally considered to be between 3% and 4%.

One might think then that long-term rates have another 200 basis points to go as well, which would mean the 10-year Treasury note would be yielding 6.20% by early 2006.

Not so fast. If past credit tightening cycles can be a guide, take a look at the analysis below:

February 30, 1999 thru May 16, 2000:

Fed Funds increased from 4.75% to 6.5% - **plus 175** basis points:
10-year Treasury note yield increased from 5.79% to 6.44% - **plus 65** basis points

February 4, 1993 thru February 1, 1995:

Fed Funds rate increased from 3% to 6% - **plus 300** basis points:
10-year Treasury note yield increased from 6.26% to 7.65% - **plus 139** basis points

January 1988 thru February 1989:*

Fed Funds rate increased from 6.50% to 9.75% - **plus 325** basis points:
10-year Treasury note yield increased from 8.67% to 9.36% - **plus 69** basis points

As you can see, in all three periods the Fed Funds rate increased substantially more than the longer Treasury bond yield. We suspect that the same trend will occur this time around. Interestingly, during several rate hike campaigns, the resulting yield on the 10-year T-note actually ends lower than the Fed Funds rate.

These yield "disconnects" are common and occur when market participants are anticipating Fed moves or in some cases, are telling the fed what to do. The futures' market has the Fed Funds rate pegged at 3% by summer 2005...in effect, it's already priced into the market.

Our economy is undergoing a sea change, moving from a manufacturing emphasis into one with an information/service emphasis. Inflation pressures once brought on by higher energy prices are effecting our GDP to a lesser degree and are being offset with lower prices on other goods and services (clothing, electronics, and especially wage inflation) causing a tamer CPI figure. Tame inflation coupled with moderate economic growth will temper Fed Rate hikes.

Remember, we are coming off of a Fed Funds rate of 1.00%. This is important. The Fed will not snuff out this recovery, however anemic, with prohibitive rates. Our advice, as always, is to set realistic goals and yield targets for your bond portfolio, ladder your maturities and stay invested! Waiting with cash in a money market account is not a strategy.

We are experts in the management of fixed income portfolios. If you have questions or concerns about your portfolio, now is the time to make adjustments for the new year. Call to schedule an appointment to review your current situation.

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