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Waiting for Higher Interest Rates?

The yield levels we are seeing today may be those higher rates that we have been waiting for. The Fed is in its longest credit tightening cycle since 1992. The Fed Funds rate, now at 3.00%, is 200 basis points higher than this time last year and yet the benchmark, 10-year Treasury Note yield has fallen over 60 basis points since this campaign began.

You have seen the analysis below in a previous letter but I think it bears repeating. You will note that in two of the credit tightening cycles, the Fed Funds rate actually ended up higher than the yield on the 10-Year Treasury Note.

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

Why are longer-term rates remaining stubbornly low even as Greenspan and friends have been raising the Fed Funds rate? Among other things, the Fed controls short-term borrowing rates. Longer-term rates move up and down on expectations of future economic growth and inflation concerns and are controlled primarily by market participants.

Put simply, here is how Fed rate hikes directly affect consumer spending. Most consumer credit rates and adjustable mortgage rates are tied to the Prime rate. This rate (usually) moves in lock step with the Fed Funds rate. As Prime increases, more money is taken from the consumer in the form of higher interest rates and therefore is not available for the purchase of goods and services.

Since consumer spending makes up roughly 2/3rds of our economy, when spending slows, the economy slows causing the Fed to pause and eventually begin cutting rates again to stimulate the economy lest it should fall into recession. Indeed, we are already seeing signs of slowing economic growth in European economies. Even China and India are slowing from their torrid pace of the past several years.

The Core Personal Consumption Expenditures Price Index (PCE) is the Fed's primary inflation index. The comfort range for this index, as far as the Fed is concerned, is when this index runs between 1% and 3%. The PCE is currently running at about a 2.4% annual rate. One may say that the Fed is blind to inflation but facts is facts, folks: minus the volatile food and energy components of the PPI and CPI, core inflation, as it is known remains tame.

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To be certain, there are innumerable factors involved here that could easily push longer-term rates up or down at the drop of a hat, such as: re-introducing the 30-year Treasury bond, tax code reform, a trade war, terrorist activity, core CPI or PPI spike, all of these things and more are very real possibilities.

As always, we recommended you set realistic yield targets for your portfolio consistent with your risk tolerance, utilize the ladder principle and consult your Bernardi Securities Investment Specialist.

Jeff Irish
Vice President

**Federal Reserve decisions were not made public during this time.*

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