First Investors Funds

Market Commentary

October 2015

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Low Long-Term Interest Rates: The New Normal?

The Federal Reserve (the Fed) has held short-term interest rates at the extraordinarily low level of 0.125 percent since 2008. During that time, long-term interest rates have also been at historically low levels. The benchmark 10-year U.S. Treasury note yield has averaged 2.8 percent since 2008. For the 10 years before then, its average yield was 4.9 percent. Many investors have expected interest rates to "normalize," that is, return to pre-2008 levels. But after eight years, the question now being asked is: Are markets in a low interest rate environment for the foreseeable future?

10 Year U.S. Treasury Yield

The question is important for people trying to decide how much money they need to save for a house, college or retirement. Simply put, the difference between 4.9 percent before 2008 and 2.7 percent since 2008 requires an investor to save 45 percent more to generate the same amount of income from a bond investment.

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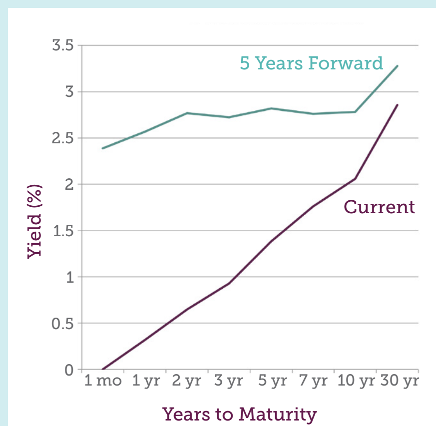
Increasingly, it appears that interest rates will remain relatively low into the future. One way of seeing this is through "forward rates" in the Treasury market. To explain forward rates, suppose an investor wants to make a 10- year investment. He could choose to buy a bond with a 10- year maturity or he could buy a bond with a five-year maturity and then in five years buy another bond with a five-year maturity. To make this decision, the investor needs to assume a five-year interest rate, five years from now. That rate is called a forward rate. In the Treasury market, forward rates exist for maturities all along the yield curve. Those forward rates are the market's forecast of where interest rates will be in the future.

So where does the market expect interest rates to be? Treasury forward rates indicate that the market expects long-term interest rates to remain low for some time. As the graph shows, the 10-year U.S. Treasury yield five years forward (i.e., in 2020) is 2.8 percent, the same as the average 10-year yield since 2008.

Forward Yield Curve



Of note, forward interest rates have been trending lower since 2013. Normally, one would expect forward interest rates to be moving higher with the economy in its sixth year of expansion and the Fed indicating that it intends to raise interest rates. In fact, one of the reasons that forward rates have been moving lower is that the Fed has waited so long to raise interest rates that the market expects it will raise them much less than in past tightening cycles. For example, in 2004-2006, the last time the Fed tightened monetary policy, it raised the federal funds rate 425 basis points (4.25 percent) from 1 percent to 5.25 percent. Currently, the Fed itself expects to raise the federal funds rate to only 3.5 percent over the next few years. And the market doesn't think the Fed will even get to 3 percent. So, if the federal funds rate never gets to 3 percent, it will be hard for long-term Treasury yields to reach that level.

Forward rates are only a forecast of the market's expectation for interest rates. What could cause interest rates to move higher than current forward rates, back to pre-2009 levels? The most likely cause would be an acceleration of inflation. But at this point, inflation remains stubbornly low despite years of very easy monetary policy. In fact, six years into the recovery, investors should perhaps be more worried about the next recession rather than an outbreak of inflation. But that's a topic for another commentary.

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