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Monthly Investment Outlook: How High Can Interest Rates Go?

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Title graphic: Fed messaging is clear

In recent years, the Federal Open Market Committee (FOMC) has attempted to be as transparent as possible about where it expects interest rates will go in the future by providing the financial markets with its "dot plot" rate estimates. Given this transparency, it came as no surprise when the Federal Reserve raised the federal funds rate on September 26th, its third rate hike of 2018. After the most recent increase, the fed funds rate is set at 2.00–2.25% going into December's FOMC meeting.

In the September meeting, the FOMC released an updated summary of "dot plot" rate projections, and it showed that 12 of the FOMC's 16 members view a December rate hike as likely. Given these expectations, coupled with recent strong economic data, we look for the Fed to increase rates at its FOMC meeting on December 18th and 19th.

As Fed rate policy becomes more restrictive, we think the Fed may end its current rate hike cycle as early as late next year.

Title graphic: How high can rates go?

As the Fed continues to raise short-term rates, we have not seen longer-term rates increase at the same pace. Short-term rates increasing faster than longer-term rates has led to the interest rate curve flattening. If the curve remains flat, or flattens further as we expect it will over time, the upside risk in long-term rates is generally limited. Yes, we believe the 10-year Treasury could and should move modestly higher as the economy continues to expand and labor markets tighten. But, we also believe that the 10-year yield will remain under 4.00% throughout this cycle. The 10 Year Treasury Yield is considered a standard indicator of long-term interest rates.

Title graphic: Investor implications

A key risk to the markets and the economy is when the Fed is too aggressive in implementing rate hikes. A Fed policy mistake—even if it occurs in slow motion—is an increasing risk, in our opinion, and could lead to slower economic growth.

For most of 2018, the bond market exhibited extremely low volatility. However, as the Fed continues to raise rates and the risks of potential policy mistakes grow, clear transparent communications can become less clear—and market uncertainty around monetary policies can increase. As a result, we see a potential for elevated bond market volatility going forward.

In the current environment, we recommend that investors favor shorter maturities over longer maturities and look for opportunities to move up in credit quality. Shorter-term, high quality securities can potentially offer investors attractive yield opportunities that we have not seen in quite some time.

Risk Considerations

All investing involves risk including the possible loss of principal. Each asset class has its own risk and return characteristics which should be evaluated carefully before making any investment decision. **Bonds** are subject to interest rate, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Bonds with longer durations are generally more price sensitive and volatile than those with shorter durations.

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