Why are rates so low and when are they going up?

Time and time again we are asked these questions by our clients. Ultimately, the Fed Funds rate drives interest rates for savings, money markets, CDs, and fixed annuities. In December 2009, the Fed Funds rate hit its one-year anniversary of remaining below .25%. The Fed continues to commit to holding rates low in the near-term, yet the steepening yield-curve indicates that rates will go up. The trillion dollar question: When? This uncertainty creates pressure from our clients to sideline cash and not maintain their long-term investment strategy. In the end, we recognize that diversifying investments and implementing solutions for various economic scenarios allow our clients to optimize their portfolio to meet their long-term objectives, rather than taking on too much risk and trying to maximize their returns at a point in time.

"Why are rates so low?"

The Federal Reserve is holding rates low in order to stimulate the economy. Historically, low rates entice consumers and businesses to spend more because money is cheap to borrow. One of several indicators the Federal Reserve uses to monitor economic activity is Gross Domestic Product (GDP). Below is more information on the recent trends in GDP and the components it measures.

"When will rates go up?"

The short answer is once the Federal Reserve believes the economy is strong enough to sustain itself. A healthy economy tends to show a moderate increase in prices, otherwise known as inflation. The Consumer Price Index is one indicator used to determine if we are in an inflationary or deflationary trend. We'll review more information on the recent CPI trends, the yield curve issue, and additional indicators the Federal Reserve uses to determine the state of the economy.

Most forecasters believe rates will remain low for some time. Most are willing to commit to a flat rate forecast for the next 6-9 months. Reality is forecasters are seldom exactly right. This leaves our clients between a rock and a hard place. Many investors continue to sit on too much cash with a very low interest rate or have fled to the "security" of bond funds. Even in a low interest rate environment, there is one question our clients can't escape, "Am I going to run out of money in retirement?" Saving and investing – not sidelining in cash positions – remains a top priority for an aging population.

What can you do to help your clients and continue to build your business in these unprecedented times? Here are two ideas you can implement today to build your credibility and your business in 2010:

1. Educate clients and prospects on the "Rate Story."
2. Offer your clients solutions that mitigate interest rate risk and keep them on track for their retirement goals.

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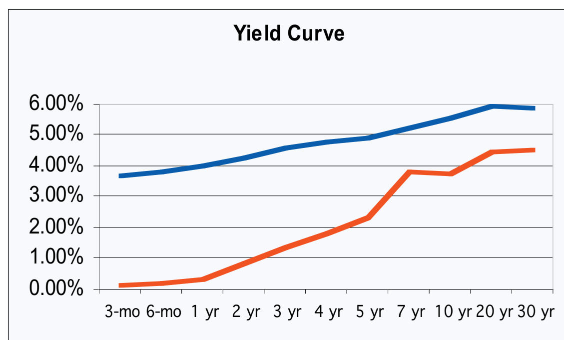
The Rate Story: What to watch and what it means

The Yield Curve Issue:

We have all heard the news...rates are eventually going to rise because we have a steep yield curve. Historically on a normal yield curve, the yield on 30-year Treasury bonds runs approximately 3% above the yield on 3-month Treasury bills. When that spread increases, the slope of the yield curve gets steeper and signals that bond investors believe the economy will improve quickly in the future and drive up inflation. We currently have a steep yield curve, with the spread between 3-month bills and 30-year bonds averaging a little over 4.5%. The difference in the shape of a normal yield curve and a steep yield curve is illustrated in the charts below.



The yield curve plots the yields of treasury bills, notes, and bonds starting with a 3-month maturity and going out to a 30-year maturity. Normally, the shorter the maturity, the lower the rate, as there is less interest rate risk in a 3-month versus a 30-year maturity.

In Diagram 1:
The historical "normal" yield curve is based on weekly averages for the period of 4/1/91 to 2/8/10. The current steep curve represents rates as of 2/8/2010.

Back to the trillion dollar question: When will rates go up? Consensus is calling for a relatively flat year. The truth, we're in uncharted waters and predicting exactly what will happen and when is close to impossible. We have never before experienced the effects massive government borrowing has on the yield curve, nor the unprecedented number of Americans rapidly approaching retirement with so little savings.

Bond investors are driving the rates up at the long end of the curve. They are counting on two things as the government continues to make more money available:

1. Consumers will have access to more money and begin spending at more normal levels, fueling an economic recovery and inflation.
2. The government will be forced to increase rates to a) attract investors to continue buying Treasury bills, notes, and bonds, and b) reduce inflationary pressure.

However, many questions remain:

1. Will consumers return to normal spending levels or will consumers behave differently in this "New Reality" we keep hearing about? In the past two years, we have seen the national savings rate increase from 0% to over 6%. At the same time, unemployment has risen to over 10% and average wages have fallen.
2. What policy decisions will be made by the current administration? Will additional stimulus plans be implemented?
3. How does the globalization of the economy over the past two decades affect the U.S. recovery? U.S. - based corporations have profited immensely from the global growth we have witnessed. As the credit markets froze and the market crashed, the U.S. fell first. Many believe the U.S. must blaze the trail for a global economic recovery.

Although it is not the answer our clients want to hear, it is impossible to predict when rates will go up, and once they start trending up, how quickly they will rise. This is unsettling, which is why so many investors are still sitting on the sidelines waiting for someone to help them understand what they should do next.

Following are some talking points around a few economic indicators intended to help you educate your clients on the rate environment and overcome the rate objection. At the end of this article, click on the link to take a two-minute survey on how helpful this article is to your business and we'll send you "Sales Solutions for 2010: Opportunities to Grow Your Business in a Flat Rate Environment".

Consumer Price Index (CPI):

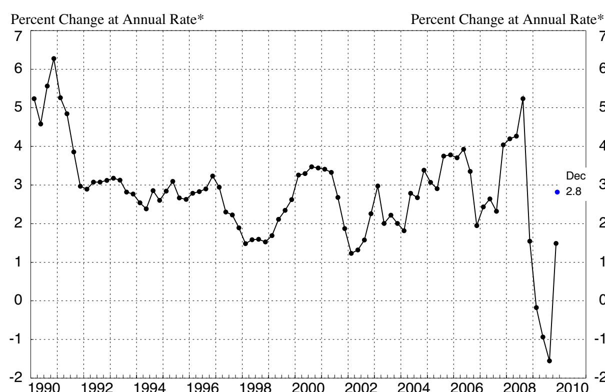
The rate of change of the CPI is one of the key measures of inflation for the U.S. economy.

The rate of inflation is important to savers and borrowers alike. If you are saving for retirement or trying to maintain your standard of living in retirement, you want to make sure the dollars you are saving today will have the same purchasing power in the future. If you are borrowing money for a house, car, college tuition, etc., the inflation assumption is one of the key drivers of the rate you will pay. After all, when lenders are paid back, they want that $1 to have the same purchasing power as when it was lent to you.

What are the recent trends?

CPI for December 2009, was reported at 2.8%. This index indicates that the prices included in the basket of goods and services measured increased at an annualized rate of 2.8%. The general rule of thumb for healthy inflation rate is 3%.[1] See the chart below for recent trends.

CONSUMER PRICE INDEX



*The change in the quarterly average level of the index, expanded to show the change that would occur over a year if change continued at the same rate.
Source: U.S. Department of Labor, Bureau of Labor Statistics

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As defined by the Federal Reserve Bank of New York, CPI is an index designed to measure the change in price of a fixed market basket of goods and services (over 10,000) and is reported on a monthly basis as an annualized percentage over the previous month's CPI. The market basket of goods and services is representative of the purchases of a typical urban consumer. Some of the more volatile components of CPI include energy and food prices.

Why is CPI relevant for understanding the direction of rates?

Acceleration or deceleration of price inflation may signal that a change in monetary policy may occur. Historically the Federal Reserve has implemented two strategies to control inflation:

1. Reducing the money supply
2. Raising rates

Gross Domestic Product (GDP):

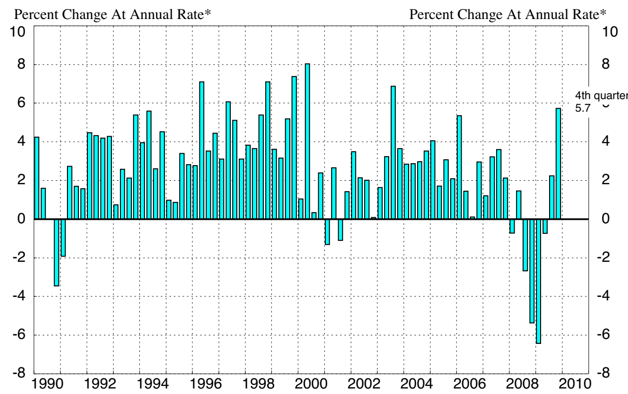
Reported quarterly, GDP is the key measure of domestic economic activity. The quarterly initial estimate is typically reported at the end of the month following the most recent quarter. Revisions typically follow during the next two months.

What are the recent trends?

3rd quarter 2009 GDP posted its first gain in 4 quarters, up 2.2%. The biggest driver in private consumption was automobile sales and in private investment was residential housing. Both were helped by government programs: Cash for Clunkers and the $8,000 tax credit for first-time home buyers. Christina Romer, chair of the White House's Council of Economic Advisors, said in a statement that stimulus added between 3- 4% to growth in the 3rd quarter, suggesting that without the government spending GDP would have remained negative.

The initial estimate of 4th quarter 2009 GDP is 5.7%. According to Christina Romer, "part of the rapid growth in real GDP was due to a substantial rise in inventory investment. This inventory bounce, though likely to be transitory, is a normal part of healthy recoveries." Revisions will follow over the next two months.

REAL GDP



*The quarterly change, expanded to show the change that would occur over a year if change continued.
Source: U.S. Department of Commerce, Bureau of Economic Analysis

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GDP is the basic measure of a country's overall economic output and is calculated by assigning a market value of all final goods and services made within a specified time frame. GDP is typically stated as an annualized percentage over the previous quarter's GDP.

Chief Economist and Strategist, David Rosenberg of Gluskin Sheff, "believes the economy would be contracting without the stimulus." He and his team ran simulations to determine what the GDP would have been without the massive stimulus. "Instead of real GDP contracting 2.4% for all of 2009, it would have been close to a 4.0% decline. And, as for the last two "positive quarters" – well, Q3 would have been -1.0% QoQ at an annual rate and -1.5% for Q4 (as opposed to +5.7%)."

Why is GDP relevant for understanding the direction of rates?

The Federal Reserve's primary goal is sustained growth of the economy with full employment and stable prices. Real GDP is the most comprehensive measure of the performance of the U.S. economy. By monitoring trends in the overall growth rate as well as the unemployment rate and the rate of inflation, policy makers are able to assess whether the current stance of monetary policy is consistent with that primary goal. A large increase in economic growth increases inflationary pressures, potentially leading the Fed to increase interest rates.

Additional Indicators:

The reality is there is not a single indicator or measure that can predict the future. Over time the Federal Reserve adjusts its indexes and indicators as economists back-test the measurement's validity in forecasting future economic conditions. Below is a list of additional economic indicators, both lagging and leading, the Federal Reserve Bank of New York uses with a number of other factors to formulate monetary policy. You can read more about each indicator and view the most recent trends at www.newyorkfed.org under the Education tab.

- Nonfarm Payroll Employment
- Housing Starts
- Industrial Production/Capacity Utilization
- Retail Sales
- Business Sales and Inventories
- Advance Durable Goods Shipments, New Orders and Unfilled Orders
- Lightweight Vehicle Sales
- Yield on 10-year Treasury Bond
- S&P 500 Index
- M2

In closing, there is no perfect crystal ball. There are many things that are out of our control…death, taxes, natural disasters as we have recently witnessed in Haiti, the economy, and rates. By sharing our knowledge, expertise, and solutions we can help our clients control their ability to meet their financial goals and keep them invested for the long-term.

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