

# ECONOMIC UPDATE:

## Interest Rate Normalization



### Richard B. Hoey Chief Economist, BNY Mellon

June 24, 2013

We continue to expect the current soft patch in economic activity to be followed by an acceleration of U.S. and global GDP growth in late 2013 and in 2014. In that context, both the Fed's contemplation of future actions to taper its quantitative easing program and the recent rise in intermediate-term and long-term interest rates appear to be cyclically appropriate. Our most likely case is a "Three for Three Pattern" for the U.S. economy. What does that mean? During the years 2014, 2015 and 2016, we expect U.S. real GDP growth to average 3% or more for three years. We expect an acceleration in economic growth in late 2013. The strengthening of U.S. economic growth should be aided by the gradual fading of both the fiscal drag and the deleveraging drag.

With the recent sharp rise in mortgage rates, we expect volatile housing data over the next several months. However, there is pent-up demographic demand for housing. Inventories of new homes and existing homes have already been sharply reduced. We continue to expect strong sustained expansion in the housing sector, despite any short-term volatility.

We expect the Federal Reserve to begin to taper its purchases of Treasury securities in late 2013, consistent with the recent guidance from Chairman Bernanke. Current economic data are below the Fed's dual mandate targets for both employment and inflation, so it is reasonable to expect the Fed to wait a few months before beginning to taper, especially given recent market turbulence. Chairman Bernanke described the Fed's intentions to begin the taper later this year. However, the "global margin call" on risky assets and repricing of bond yields triggered by the Fed's policy shift is tightening financial conditions worldwide. In the U.S., a financial tightening is reflected in rising real yields, with nominal

yields rising and inflation and inflation expectations falling. The timing of tapering is not predetermined but is data dependent. Chairman Bernanke stated that "...if financial conditions move in a way that make this economic scenario unlikely, for example, then that would be a reason for us to adjust our policy. ...we have no deterministic or fixed plan. Rather, our policies are going to depend on this scenario coming true. If it doesn't come true, we'll adjust our policies to that."

The economic impact of an interest rate rise is very sensitive to the cyclical stage of monetary policy. In our view, there are five stages of monetary policy: (1) aggressively stimulative (2) stimulative, (3) neutral, (4) restrictive and (5) aggressively restrictive. The Federal Reserve plans a gradual move from aggressively stimulative to merely stimulative, in response to evidence that the U.S. economy is in a sustainable economic expansion. We doubt that this move to a somewhat less stimulative policy is going to disrupt the U.S. economic expansion in any major way, although it may create volatile data in the short run. It is occurring in response to favorable news on the sustainability of economic expansion rather than any unfavorable news of excessive inflation. Inflation is below the Fed's target and inflation expectations have shifted lower. Interest rates are not rising because of excessive inflation but rather because the Fed intends to withdraw its program of driving bond yields below free-market levels.

We believe that monetary policy shifts at a later stage of the business and monetary policy cycle can be more damaging. If inflation surges above the central bank's tolerance limit and the Fed moves from neutral to restrictive and then to aggressively restrictive, the result can be a credit crunch, recession and sharp decline in



BNY MELLON

profits. But that's not what we're dealing with today. We expect that it will be many years in the future before the Fed shifts to a restrictive or aggressively restrictive monetary policy.

The markets have tended to treat the Federal Reserve's discussion of tapering quantitative easing as a signal that the timing of the first Fed rate hike is likely to be accelerated. However, concerns at the Federal Reserve about potential negative side effects appear to be much greater for quantitative easing than for the zero Federal funds rate. Quantitative easing was driving down perceptions of risk to extreme levels, which has just been substantially corrected by indications of potential tapering. We continue to expect that the first Federal funds rate hike is likely to be postponed until 2015.

QE3 was basically designed to force long-term interest rates below their free-market clearing level in order to drive up asset prices and support economic expansion. Prior to indications from the Fed on May 22, 2013, indicating potential tapering, there were clear signs of more aggressive risk-taking in many markets. We do believe that excessively easy Federal Reserve policy contributed to the internet bubble in 1999 and early 2000 and the housing bubble in the mid-2000s, so concerns by central bankers and market participants about excessive risk-taking in response to hyperstimulative monetary policy seem appropriate. So far, however, the magnitude of risk excesses has been much more muted in this cycle. Markets where risk-taking was embodied in "crowded trades" have recently corrected after the Fed indicated that it would soon begin to taper quantitative easing.

There has been a recent "bear steepening" in the bond market, with intermediate and long-term interest rates rising even as short rates are firmly locked near zero by the Fed's policy. We put this rise in intermediate-term and long-term interest rates in the context of a gradual multiyear interest rate normalization which we expect to occur during a multiyear economic expansion. The lesson of economic history is that a rise in interest rates is a normal pattern in prolonged economic expansions. The onset of the normal cyclical rise in interest rates was delayed this cycle due to the severity of the financial crisis and recession and by Federal Reserve actions to hold down bond yields, but the normal cyclical pattern is now emerging.

Historically, the yield curve has been a leading indicator. When short-term rates rise faster than long-term rates, first flattening and then inverting the yield curve, that has been a warning sign for economic activity. The recent

steepening of the yield curve tends to be more consistent with sustained economic expansion. The marginal profitability of expanding bank credit tends to be more favorable when the yield curve is steep. However, an offset may come from current tightening and expected future tightening of bank regulation. While monetary policy has been very stimulative, financial regulation has tightened, leaving net monetary policy moderately stimulative even though gross monetary policy is aggressively stimulative. Recent market turbulence may restrain the desire of regulators for additional rounds of regulatory tightening, since that might exacerbate the effect of the Fed's tapering of quantitative easing.

The U.S. has benefited from declining interest rates for about three decades. We outlined the logic for a persistent decline in long-term yields in our May 25, 1981 Forbes column, entitled "Last Chance This Century." The actual long-term secular decline in long-term interest rates lasted nearly 31 years, with 10-year U.S. Treasury yields peaking at 16% on September 30, 1981 and troughing below 1.4% in late July 2012, a decline of over 1400 basis points over a period of more than three decades. We believe that the three-decade-long secular bond bull market is over. After all, the long-term declining trendline of 10-year bond yields was destined to be broken eventually unless yields dropped another 1400 basis points over the next three decades, to about minus 12%. This appears to be quite unlikely, so an eventual break in the long-term declining trendline in interest rates should hardly be a surprise.

We believe that a persistent multiyear upward drift in interest rates is now likely. The aftermath of the three-decade-long decline in interest rates is likely to be labeled a secular bond bear market, but we prefer to view it in the context of the cyclical normalization of interest rates that we expect over a half-decade period. If we are correct to expect real GDP growth of 3% or more for the next three years, 10-year Treasury bond yields are likely to eventually normalize at about 5% at the end of a half-decade-long process of interest rate normalization. Following the rise of about 100 basis points in 10-year Treasury yields since their secular and cyclical lows below 1.4% in July 2012, we expect that the pace of increase in 10-year Treasury bond yields should be gradual from now on, with the 12-month moving average likely to drift higher at a pace of about 50 basis points a year.

Ten-year Treasury bond yields have nearly doubled in the last 11 months, illustrating how extremely depressed bond yields were to begin with. We expect them to

double again over the course of a number of years. The recent rapid rise in bond yields may be sufficient to generate a plateau in interest rates for the next several months. While we expect the upward drift in interest rates to occur in a volatile and choppy pattern, a drift higher in 10-year Treasury yields at an average pace of about 12 basis points a quarter over the course of a half-decade is hardly likely to disrupt U.S. economic expansion, in our opinion. Some of the severity of the recent sell off in the bond market and other markets was the result of the unwind of leveraged positions at expensive asset prices, which were priced to the expectation that the Fed would continue to hold bond yields below free market levels. From a short-term perspective, the recent sell-off has done much to correct that mispricing. In summary, we expect a prolonged upward drift in interest rates over the coming years, but recognize that substantial short-term adjustment has already occurred.

The China boom has decelerated into a China expansion as structural adjustments are occurring. For demographic reasons, new entrants to the labor force have dropped. Despite an ample supply of white collar workers, the supply/demand balance for blue-collar workers has

tightened. In response to this reality, the Chinese government has tolerated a wage inflation, making China less competitive for low wage industries. China now faces several financial issues, notably including poor capital discipline in capital spending decisions. China faces an overhang from past malinvestment. In addition, the authorities have begun to damp down on high risk financial behavior. We believe that China has the financial resources to deal with these issues, but for now they are contributing to a slower pace of expansion. We expect two developments to aid the Chinese economy by 2014. By then, we expect a better-defined economic growth strategy in China. Second, we expect stronger global demand in 2014, supporting exports from China.

In Europe, the good news is that the overall economic decline appears to be ending. The bad news is that fundamental policy problems have not been resolved. Much of Europe still has a combination of relatively inflexible labor markets and growth-restraining economic policies. In addition, Europe has been slower than the U.S. to strengthen its banking system, so its ability to support economic expansion is damaged. We do expect an economic recovery in Europe to start soon, but expect it to be quite weak.



## BNY MELLON

BNY Mellon Investment Management is one of the world's leading investment management organizations and one of the top U.S. wealth managers, encompassing BNY Mellon's affiliated investment management firms, wealth management services and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole or its various subsidiaries generally. • The statements and opinions expressed in this document are those of the author as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This article is of a general nature, does not constitute legal, accounting, tax or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. • Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. • While the information in this document is not intended to be investment advice, it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors. • Products or services described in this document are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. This document may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this document comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this document in their jurisdiction. • **The investment products or services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.** • This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited.

In **Australia**, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. • In **Brazil**, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. • In **Canada**, interests in any investment vehicles may be offered and sold through BNY Mellon Asset Management Canada, Ltd., a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager. • In **Dubai, United Arab Emirates**, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. • In **Germany**, this document is issued by Meriten Investment Management GmbH (formerly named WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH), which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. • If this document is used or distributed in **Hong Kong**, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Unit 1501-1503, 15/F Vicwood Plaza, 199 Des Voeux Road, Central, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities, and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. • In **Japan**, this document is issued by BNY Mellon Asset Management Japan Limited, Marunouchi Trust Tower Main Building, 1-8-3 Marunouchi Chiyoda-ku, Tokyo 100-0005. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • In **Korea**, this document is issued by BNY Mellon AM Korea Limited for presentation to professional investors. BNY Mellon AM Korea Limited, 21/F Seoul Finance Center, 84 Taepyeongro 1-ga, Jung-gu, Seoul, Korea. Regulated by the Financial Supervisory Service. In **Singapore**, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. • This document is issued in the **UK** and in **mainland Europe** (excluding Germany), by BNY Mellon Asset Management International Limited. BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. • This document is issued in the **United States** by BNY Mellon Asset Management. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.

本情報提供資料は、BNY メロン・グループ（BNY メロンを最終親会社とするグループの総称です）の資産運用会社が提供する情報について、BNY メロン・アセット・マネジメント・ジャパン株式会社が審査の上、掲載したものです。当資料は情報の提供を目的としたもので、勧誘を目的としたものではありません。当資料は信頼できると思われる情報に基づき作成されていますが、その正確性、完全性を保証するものではありません。ここに示された意見などは、作成時点での見解であり、事前の連絡無しに変更される事もあります。

BNY メロン・アセット・マネジメント・ジャパン株式会社  
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号  
〔加入協会〕 一般社団法人 投資信託協会  
一般社団法人 日本投資顧問業協会