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Interest Rates: What Will "Normal" Look Like?

Key Takeaways

- Fed Chairman Powell last week counseled for patience as the Fed's preferred inflation measure continues to slow even while remaining above the long-term target of 2%. If US employment growth remains on a slowing trend, we see the Fed being able to reverse a portion of its large tightening steps of the past two years, with the first steps taken this year. If we are wrong and the Fed cuts rates later than we expect, the exact timing shouldn't matter much for most asset prices.
- We believe the post-pandemic inflation surge jarred the world out of complacency about inflation risk. While the Fed has largely succeeded in shutting down any lasting rise in inflation expectations, there is greater risk premia in real bond yields.
- For the fixed income portion of an average investor's asset allocation, we see the greatest value in high-grade intermediate-duration bonds. Across a range of bond segments, average yields are near 6.0% for 4-5 years. This is much higher than the Fed's estimate of its "longer-run" normal policy rate (2.6%).

Portfolio Implications

The real Fed Funds rate is currently 2.6 percentage points above the Fed's preferred core inflation measure. This is above the 2.3 percent that prevailed from 1994-2007 (a period of strong underlying growth) and the 0.6% the Fed sees as "longer-term normal" now.

Even if bond prices don't surge, current yields are providing a much higher and more predictable source of return. Reinvesting fixed income proceeds as they mature can be expected to deliver a more durable flow of consistent income in the future.

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Which Normal Will We Revert To?

Where inflation and interest rates settle is a critical question for investors. In our view, the number of Fed rate cuts in the shrinking 2024 calendar is not where concerns should lie. History shows the lurch to judgement on US rates is often inaccurate and expectations unstable (please see our April 21st CIO Bulletin). The most relevant questions for investors are:

1. Under what economic conditions will US monetary policy ease, if at all?
2. Where are interest rates really headed over the longer run?

Long-term bond yields, the broad cost of debt capital, and exchange rates globally will be set by the answer to the latter question.

What will it take for the Fed to Ease?

The Fed concluded early in 2024 that it could unwind a portion of its extreme monetary policy tightening actions and help achieve an uninterrupted economic expansion during the next two and a half years. Such predictions can't properly account for any unknowable shocks that might interrupt the economy. But we wholeheartedly agree with the Fed's basic premise.

Monetary policy tightening, Covid-era supply constraints easing, and moderation of wild demand swings are all contributing to a gradual slowing in inflation. The very similar rise and fall in inflation across the globe points to common, severe, but mostly temporary factors (see **FIGURES 1 & 2**). As we discussed in our April *Quadrant*, there seems to be much less divergence between US and European inflation readings than meets the eye.

Of course, if demand in the US were to persistently outstrip supply for goods and services, the Fed could be forced to hold to a restrictive monetary policy for longer or even resume tightening. As a base case, however, we continue to believe the Fed will be able to begin partially unwinding the sharp tightening steps that culminated in a 5.5% Fed Funds rate later this year.

FIGURE 1: US and global inflation: *pandemic similar* (monthly US data, annual global data)

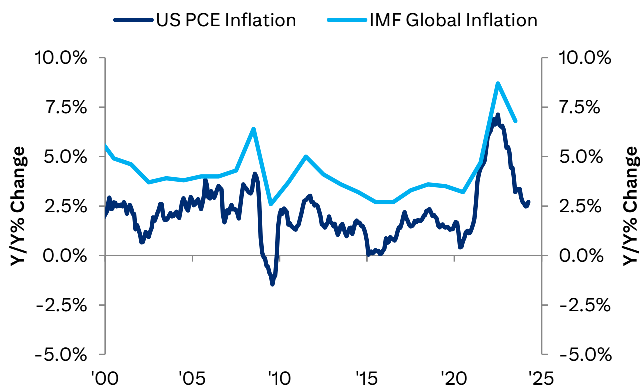
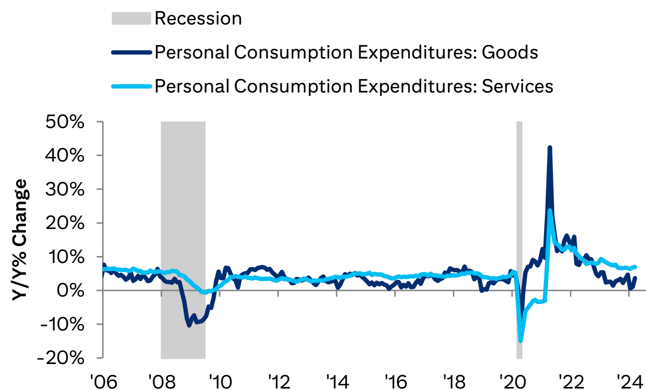


FIGURE 2: Consumer demand upheaval moderating



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Whether, and more importantly *why,* US policy easing starts this year will help shape the trajectory for global markets and the economic outlook. In the first quarter 2024, 269,000 jobs were added on average per month in the US. If that pace continued all year, the Fed would likely need to stay on hold with policy rates at their historically high levels (relative to inflation, see **FIGURE 3**). April showed a slowdown to a 175,000 gain. While we would normally advise against reading much into a single monthly observation, we think the slowdown in hiring is indicative of the path to come (see **FIGURE 4**).

Rebounding from the pandemic, US employment grew by 6.6 million in 2021 before slowing to gains of 4.5 million in 2022 and 3.0 million in 2023. A trajectory pointing to below 2 million job gains in the year ahead – if accompanied by signs that the rebound in inflation has run its course – should be enough to revive easing expectations. Fed Chairman Powell's press comments last week were entirely in line with this view amid market fears that easing in 2024 is out of reach.

FIGURE 3: US core PCE Inflation Y/Y% vs Fed Funds rate

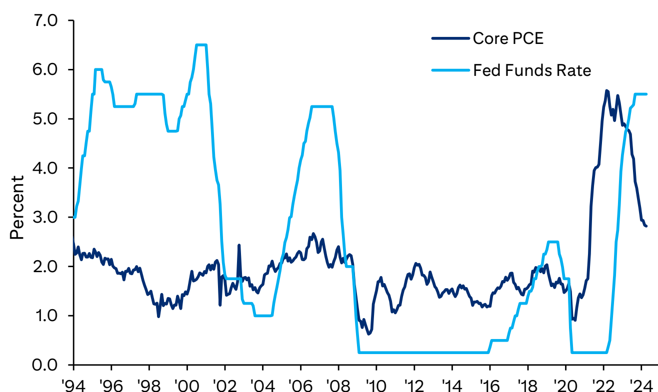
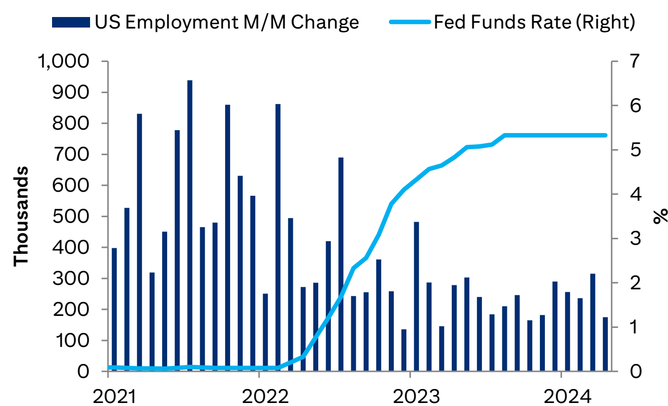


FIGURE 4: US employment monthly change



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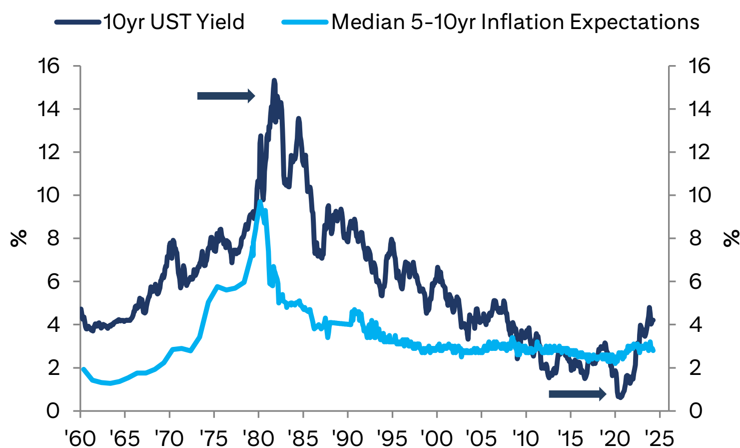
Can You Even Remember "Normal?"

More important than short-term views is what to expect from the average US policy rate in the years to come. This "neutral" rate is the rate generally consistent with economic stability. We believe the Fed Funds rate will be closer to norms from before the Global Financial Crisis (GFC) of 2008/2009, rather than the ultra-low period that followed, particularly the "zero" of 2021 and negative nominal yields of some other developed market central banks.

"Normal" is neither the historical aberration of 1980 (double digit interest rates after a decade of accelerating inflation) nor 2020 (zero or negative policy rates, see **FIGURE 5**). It's a rate that should "average in" periods of recession (and early recovery) when the Fed is unusually accommodative. The Fed now estimates this "longer run" average rate at 2.6%.

In our view, in a future recession of historic average magnitude, the US policy rate could fall to 2% rather than 0%. Many investors anchor expectations to the two most recent recessions – a pandemic and an intense banking crisis – which were particularly severe and required unconventional government stimulus. With rates less likely to fall to 0% in the next recession, the longer-run average interest rate could be at least 3.0%. This points to long-term US Treasury yields having reasonable value above 4.0%. However, the actual rate will vary from this and perhaps for a significant period of time.

FIGURE 5: Positive real yields: US Treasury 10-year yield and consumer 5-10 year median inflation expectation



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The Good Old Days of Higher Yields

In the period from 1994 through 2007, US nominal GDP growth averaged 5.5%. Core PCE (the Fed's preferred forward-looking inflation measure) averaged about 1.9%, close to the subsequently adopted Fed target of 2%. Over the same period, the Fed Funds rate averaged about 4.2%, or 2.3 percentage points above the inflation rate of that period. Therefore, this period was one of higher real interest rates than the Fed projects looking forward now.

Why were real Fed policy rates so high? Much of the 1994-2007 period was one of strong underlying *potential* economic growth, a key factor in assessing what real interest rate can be sustained. While there were stronger periods earlier in US history, the US labor force expanded by 18% over these 13 years led by a nearly 12 million jump from women entering the workforce. As the internet emerged as an accessible tool for the first time, business labor productivity grew by 2.5% per year. In essence, potential economic growth was over 3.5% during the period.

Despite favorable supply growth in the economy, the period also included two great bubbles that burst: tech-related equities and housing. Yet the speed of real economic growth was generally a positive surprise while inflation was surprisingly low.

Today's Fed Funds rate of 5.375% is about 2.6 percentage points above current core PCE, lending credence to the idea that current monetary policy is quite restrictive when compared to historical averages. At the same time, there have been positive surprises to potential economic growth. Immigration to the US stalled during the pandemic. As **FIGURE 6** shows, US population and labor force growth snapped back sharply as immigration restrictions eased. This resulted in a sharp upward revision to the US Congressional Budget Office's estimates of population and labor force between 2022 and 2024. While this could push the sustainable interest rate higher, a pandemic-related swing is not a demographic feature that would be a long-term source of labor force growth.

Investment in Artificial Intelligence (AI) services, and their likely efficacy in labor-saving/output-increasing applications, is likely the closest analog to the strong technological developments of the 1990s. Yet the macro-economic data has not, to date, suggested either a very large spending boom on capital equipment and software overall or much, if any, displacement in labor demand. With this said, we are very open to the view that AI will prove to be a highly significant "positive productivity shock" that's in its early stages (see **FIGURE 7**). To the extent that it reduces labor demand in an economy with slack, it could contribute to lower rates over the short-term. If it raises the economy's longer-term "speed limit," it would push the neutral interest rate higher.

FIGURE 6: CBO estimates of the US population growth rate through 2030: 2022 vs 2024 estimates

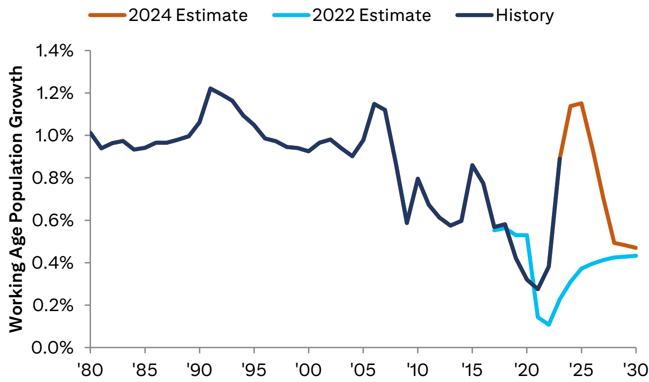
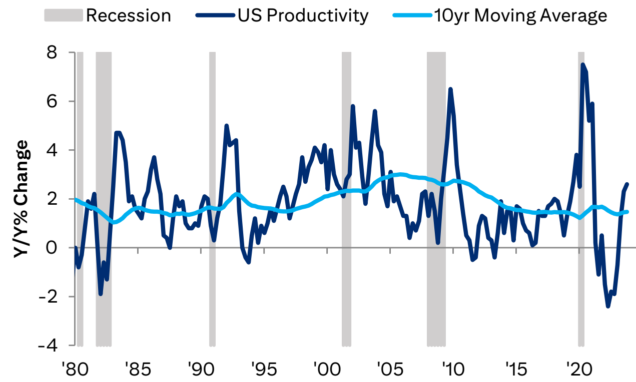


FIGURE 7: US labor productivity growth and periods of recession



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(Somewhat) Higher for Longer

In general, we believe the post-pandemic inflation has jarred the world out of complacency about inflation risk. The Fed has largely succeeded in shutting down any lasting rise in inflation expectations as **FIGURE 5** showed. But there is greater risk premia in yields, and this is likely to continue as evidenced by high current TIPS real yields (see **FIGURE 8**).

While surprising positive supply-side growth developments should help keep inflation expectations largely in check, the threat of future inflation rebounding remains due to higher expected fiscal deficit spending to mitigate economic security issues such as reshoring, defense, and climate transition. Fiscal deficit spending growth is expected to moderate in coming years, yet it may nevertheless result in a persistence of real yields similar to those experienced in the “pre-QE” years prior to the Global Financial Crisis period of 2008-2010.

Yet real yields are already at or above these historic levels. This is good news for fixed income investors. While yield levels may not drop quickly and offer a large “snap higher” in bond prices, current income is higher and we expect reinvesting fixed income proceeds will deliver a stronger and more consistent income in the future.

FIGURE 8: US Treasury Inflation Protected Securities (Real) Yields %

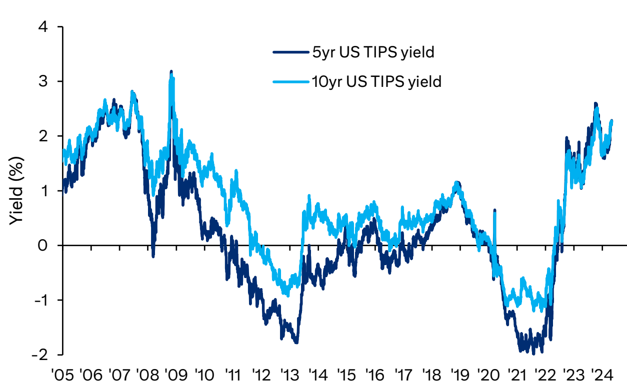
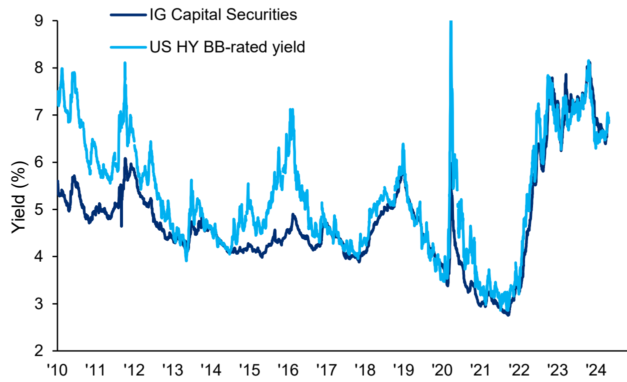


FIGURE 9: US preferreds yield vs BB-rated corporates



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Fixed Income Investment Recommendations:

- We continue to advocate maintaining duration around 4-5 years for overall fixed income portfolios. US investment grade (IG) credit spreads remain very tight, about 80bps currently. While this spread is low, it is still incremental yield in addition to Treasury yields, and thus provides some additional income for core fixed income holdings.
- For US-based investors who can maximize the tax benefits, select investment grade municipal bonds can also provide additional yield benefit over Treasury yields. In addition, both intermediate investment grade corporate bonds and tax-adjusted municipal credit still offer a much higher yield than expected inflation.
- We also suggest that suitable clients should consider low BBB-rated and BB (high yield) corporate bonds, where one can potentially earn additional spread over the intermediate IG corporate index.
- We are also particularly constructive on “structured credit” for suitable and qualified investors. This includes Agency AAA-rated mortgage-backed securities (MBS) which are currently offering yields in excess of the corporate IG index.
- Finally, suitable investors may want to consider an allocation to IG preferred securities. Yields for these IG securities are currently slightly higher than the BB-rated high yield index (**FIGURE 9**). Additionally, depending on structure, many of the US-based preferred issues’ interest distributions are taxed as dividend income, which can have a preferential tax rate for certain US taxpayers, and so potentially increases the pre-tax equivalent yield.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
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- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
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- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

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