Perspectives
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LEGACY
WEALTH MANAGEMENT
Missoula (406) 541-6701
Great Falls (406) 604-4970
www.legacywealthmt.com

Rising Rates: Understanding Changes in Interest Rates

By PGIM Investments

Navigating the fixed income market can be daunting for the average investor. Understanding how and why interest rates move can help us make better informed decisions about our investments.

The term interest rate can be a bit ambiguous. When you see headlines about rising rates, it often refers to an increase in the fed funds rate (the very short-term interest rate at which banks lend to each other) or an increase in longer-term U.S. Treasury rates. These rates and the differences between them are largely determined by economic factors.

Understanding the Factors That Drive Short- and Long-term Rates

In the U.S., short-term interest rates are strongly influenced by the Federal Reserve, which was created by Congress to provide a flexible and stable financial system. The Federal Reserve implements monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices. When growth is slowing, the Federal Reserve may decide to lower short-term rates (i.e. fed funds rate) to help stimulate the economy. The expectation is that lower rates will promote borrowing, which in turn promotes spending and business expansion. Alternatively, if the economy seems to be growing too fast, creating high inflation, the Federal Reserve may raise short-term rates in an effort to slow down the economy. The higher rates make borrowing less attractive and are intended to reduce spending, which should help rein in inflation.

Long-term rates, conversely, are primarily influenced by long-term expectations for U.S. economic growth and inflation. So if inflation is high, for example, a bond holder would want to be compensated for the climbing value of the money they lent out. Long-term rates may also be affected by current long-term global market rates, which is a trend we are seeing today. While U.S. rates may seem low relative to historic averages, domestic long-term rates are currently well above those in other developed markets. As a result, U.S. investments are in high demand as investors around the world search for yield. This demand puts downward pressure on the long-term yields in the U.S.

Economic Factors Affecting Short-term and Long-term Government Rates

	Short-term rates	Long-term rates
Driver	■ Federal Reserve ■ Monetary Policy	■ U.S. Gross Domestic Product (GDP)
Key Factors	■ Short-term U.S. Inflation Expectations ■ U.S. Unemployment Rate (%) ■ Short-term U.S. GDP Growth Expectations	■ Long-term U.S. Inflation Expectations ■ Long-term U.S. GDP Growth Expectations
External Factors	■ Short-term Global Inflation Expectations ■ Short-term Global GDP Growth Expectations	■ Long-term Global Inflation Expectations ■ Long-term Global GDP Growth Expectations ■ Current Long-term Global Market Rates

Source: PGIM Investments

GDP stands for gross domestic product and is a monetary measure of the value of goods and services produced in a country's borders. It is used to determine economic performance of a country.

Monetary policy is a tool used by a monetary authority to control the supply of money.

Fixed income investments are subject to interest rate risk, and their value will decline as interest rates rise.

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The Implications of an Inverted Yield Curve

By Jennifer Hutchins, CFA, Portfolio Manager, 1st Global

An inversion of the U.S. Treasury yield curve has historically been viewed as a sign of an approaching recession, but before fleeing the market, investors should consider an inversion within the context of the current market environment.

First we must define what is meant by "inversion." A typical U.S. Treasury yield curve is upward sloping, with longer-term bonds yielding more than shorter-term bonds. The yield curve is said to be "inverted" when shorter-term Treasury securities are yielding more than longer-term Treasuries. Recently, we have seen parts of the Treasury slope invert, with the 2-year U.S. Treasury yielding more than the 5-year. However, as of Dec. 12, 2018, both the 7-year and the 10-year U.S. Treasury are yielding more than the 2-year note. What does this mean for investors?

In the U.S., there appears to be a link between inversion and recession, albeit with only a few data points to include. However, we are in a different market environment than is typically seen at the end of an expansionary period. Normally, a recession is driven by an over-heating market with rising inflation that the Federal Reserve tries to repress by raising interest rates. Today's economic environment, however, is characterized with muted inflation and rates below the perceived neutral rate. Moreover, quantitative easing, an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply, has kept rates unnaturally low, placing pressure on term premiums as well. Today's inflation risk seems less obvious than historically seen at the end of an expansionary phase.

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>
> Investors should continue to work with their trusted advisors to adhere to the long-term plan that has been put in place.

While the inversion of the U.S. Treasury yield curve has been a predecessor to several recessions since 1970, the sample size was small, with approximately seven recessions since 1970. By increasing the sample size to five of the largest developed countries (Australia, Germany, Japan, the U.K., and the U.S.), one can get a better perspective of the inverted yield curve indicator. Collectively, the returns of local currency indices increased 86 percent of the time during a 12-month period after an inversion and 71 percent 36 months after an inversion. Thus, a yield curve inversion does not always mean a recession may be imminent.

Lastly, the amount of time before a bear market strikes can vary, and investors can potentially miss out on significant gains if they pull out of the market too early. The yield curve inverted in February 2006, well before the down market swing in October 2007 that preceded the 2008 financial crisis. Yet if one had pulled out of the market in February 2006, one would have missed out on a 12-percent gain posted by the S&P 500 over the next 12 months. In fact, if one pulled out prior to Oct. 14, 2007, one would have missed out on a cumulative 25 percent gain in the S&P 500 from March 1, 2006 through Oct. 14, 2007. Also, in 1998 the yield curved inverted briefly and a recession did not follow.

While no one knows whether a recession will follow the recent curve inversion, this is certain: markets go up and down, and trying to time the market perfectly is nearly impossible. Investors should continue to work with their trusted advisors to adhere to the long-term plan that has been put in place.

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