When Will Interest Rates Rise?

SYNOPSIS

- Conservative investors are anxious to return to the days when bank CDs and money market funds could be used to generate low-risk returns.
- Although it's impossible to time when the Fed will move to raise interest rates, it's likely not happening in 2015 due to inflation expectations and a stronger U.S. dollar.
- The ironic reality for conservative investors is that the first interest rate hike by the Fed is almost meaningless to the near-term returns on cash investments.

THE GOOD OL' DAYS

Conservative investors have realized next to no return on bank CDs, money market funds, and other cash investments since the financial crisis in 2008. This war on seniors and savers has forced investors to choose to earn nothing in cash or use risky investments to generate an attractive return.

Expectations around when the Fed will raise interest rates has become the talk of both Wall Street and Main Street, as investors yearn for the days when a bank CD paid 5% in yield. I've received countless inquiries from investors asking this very question, so let's run through a quick but thorough analysis to determine when we could see the first rate hike by the Fed.

In order to answer the question of when rates will rise, it's first important to understand why the Fed would even want to raise rates.

If our economy is growing very fast, overall demand for products rises as consumers and businesses spend rapidly, which will often cause inflation to surge. Too much inflation can be devastating, so the Fed tries to manage the level of inflation in our economy at all times.

The fed will begin to slowly raise interest rates in an attempt to moderate rising inflation. This strategy is effective because higher rates make borrowing money less appealing. For example, if the interest rate on a new car loan rises, a consumer may postpone the purchase.

On the flip side, if our economy is in a recession, consumers are likely worried about taking on more debt to fund new purchases. Here the Fed will cut interest rates in order to make that new car purchase more affordable, which can stimulate broad-based consumer spending.

Therefore, the Fed is extremely focused on keeping the rate of inflation within a very narrow band in order to maintain a healthy level of economic growth. They aim for a "Goldilocks" level of 2.0%, where there's enough inflation to keep wages and prices rising but not enough to cause damage. The Fed will start getting nervous in the 2.5% - 3.0% range.

INFLATION AND THE DOLLAR

Now that we have a handle on why the Fed is so focused on inflation, let's discuss why I believe that the inflation outlook and a stronger U.S. dollar will prevent the Fed from raising rates in this year.

The Fed uses the Personal Consumption Expenditures Index (PCE) as their preferred gauge for inflation, and it currently reads 1.17% (well below their 2.0% goal). Looking forward into

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2015, I believe that inflation will not exceed their threshold for three key reasons:

1. **Wages:** Inflation is a byproduct of rising wages because consumers that make more money tend to spend more money. More spending creates additional demand for goods, which pushes prices up in the broader economy. Currently, the economic data for wages confirms the long standing trend of next to no wage growth, despite the ever falling unemployment rate.
2. **Oil Prices:** Cheaper oil should drive down the cost of electricity, gasoline, and everyday items as the input costs are lowered for the companies that produce these goods.
3. **Commodity Super-Cycle is Over:** Slower global growth is weakening demand for copper, steel, and other commodities. The glory days of the 2000s appear to be over.

The net effect of these forces will likely keep inflation lower for longer, and the Fed has little reason to slow down our economy when it's not even growing all that fast.

***NOTE**: Another way to create rampant inflation in an economy is to print more currency, which is precisely how Zimbabwe ended up with a one hundred trillion dollar bill (see below). Many investors are confused over why the U.S. has not seen rising inflation due to its years of "printing" through the several rounds of Quantitative Easing.*

Source: www.wikipedia.com

The reason why inflation has not overwhelmed our economy is because the money being "printed" is not actually making it into our economy. Instead, the government is creating money and then placing it in banks for protection against another financial crisis. Meaning, this money is not being lent out to the public, and hence, the supply of money available to the general public has remained relatively constant.

A strengthening U.S. dollar relative to other developed and emerging market currencies is the second reason why I don't think the Fed will raise rates this year. The U.S. dollar has surged over the last two years, which is great for those who have traveled in Europe or Japan recently.

However, the Fed is likely concerned over a rising dollar for two key reasons:

1. **Exports Become Unattractive:** As the dollar gains strength, other currencies lose strength. Therefore, demand for our exports suffer because they are more expensive to foreigners (which could even be added to the list above for reasons why inflation is expected to remain low).
2. **Investment leaves for the U.S.:** If investors can earn a better rate of return in the U.S. from higher interest rates, particularly on a risk-adjusted basis, then investors outside the U.S. would likely be attracted here. As investment leaves many of these already shaky economies, it could throw gasoline on a flame. The Fed is acutely aware of this phenomenon and will most likely take this into consideration.

Simply put, the Fed has no incentive to raise interest rates anytime soon given current inflation trends and the continued rise in value of the U.S. dollar.

IMPLICATIONS FOR INVESTORS

The unfortunate reality is that there is no crystal ball that can tell us precisely when the Fed will act. I don't even think Janet Yellen knows when

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interest rates will ultimately rise, so handicapping government policy that is as incredibly subjective as a rate hike is a dangerous game.

Our portfolios will remain positioned to see rates lower for longer until we start to see any real signs of inflation in the broader economy. As these take root, only then will we begin transitioning our allocation over to one that should benefit with rising short-term interest rates.

Where I am highly confident in my prediction on the future of interest rates is on their impact to conservative investors. Therefore, remember these two conclusions on the day when rates actually do begin to go up:

1. **Rates Will Rise VERY Slowly:** The Fed is acutely aware of the impact to our economy if they move too far too fast. They learned their lesson after the Great Depression, and they will raise rates incredibly slow to prevent our economy from falling back into a recession.
2. **Banks Won't Move Quickly:** Even if the Fed raises interest rates next week, bank CDs will not bump up their yield offered for some time. This rate is a competitive one, and banks are flush with cash and don't need more deposits at the moment.

The bottom line is that when the Fed executes its first rate hike is practically meaningless to conservative investors because the move will have next to no impact on the yield offered from bank CDs. Hence, investors sitting in cash are going to continue to earn no return for several years to come.

Sincerely,

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