Key Questions

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Are Long-Term Interest Rates Heading Higher?

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A sharp increase in long-term rates could have a profound impact on investors' portfolios.

Since the start of January, the 10-year US Treasury note yield has climbed 25 basis points to 1.16%. With short-term US Treasury yields anchored by the near-zero federal funds rate and limited volatility in the intermediate maturities due to the Federal Reserve's (Fed) Treasury purchases, fluctuations in long-term interest rates will drive changes in the shape of the Treasury yield curve.

A steepening yield curve is typically viewed as a positive sign for the economy, the stock market, and corporate earnings, while a flattening curve sends a warning that economic weakness lies ahead. The yield curve has been steepening over the past several months, reflecting heightened growth and inflation expectations. The potential for additional fiscal stimulus provides another boost to long-term rates.

The yield curve is also steepening as downside risks to the economy are fading. The spread between the 2-year US Treasury note yield and the 10-year US Treasury note yield — a gauge of the yield curve's slope — stands at 1.06 percentage points, the widest level since May 2017. This difference between short- and long-term interest rates is edging higher as the 10-year yield rises. With the Fed on hold for the foreseeable future, we could see long-term interest rates continue to move higher toward 1.50% and signal that inflation is on the horizon. We believe that trends in growth and inflation expectations are the main drivers of Treasury rates.

In August of 2020, the Federal Open Market Committee (FOMC) announced a shift to a policy that will seek to achieve inflation that averages 2% over time rather than a precise 2% target.

This change in policy implies that the Fed will allow inflation to run at a pace above 2% for a period of time to offset the undershooting of its inflation target over most of the past decade. In other words, the Fed is willing to allow inflation to run hotter than normal in order to support the labor market and broader economy.

The biggest risk of the policy shift is that long-term interest rates could rise very quickly if investors believe that the Fed would not respond to inflation fast enough to contain it. This is important because interest rates can have a profound impact on investors' fixed income portfolios: Falling interest rates lead to higher bond prices, whereas rising interest rates lead to lower bond prices. Said another way, as interest rates rise, the value of existing bond values falls, all else being equal. This is why bond investors pay close attention to interest rate forecasts.

The economic recovery is expected to accelerate in the second half of 2021, and inflation is likely to surprise on the upside and test the Fed's commitment to its new policy shift, also known as the average inflation targeting (AIT) framework. The five-year breakeven — a bond market measure of inflation expectations — hit a seven year high at 2.30%, suggesting investors expect inflation to average that level over the next five years. We would expect to see long-term interest rates continue to rise with the expectation that inflation will pick up as the economy reopens.

At the same time, with razor-thin control of the Senate, a modest majority in the House of Representatives, and control of the White House, Democrats appear poised to pass more stimulus legislation, such as $1,400 payments to individuals and aid to state and local governments. The resulting boost to economic growth could push interest rates even higher.

Furthermore, larger budget deficits may lift rates as the supply of government debt offered to investors grows.

With economic data projected to reflect an improving outlook for this year, we anticipate that long-term interest rates could continue to move higher, with short- and intermediate-term yields staying relatively steady. Over the past month, more positive risk sentiment has led to higher long-term rates and a steeper yield curve.

With this dynamic likely to remain in place, we expect the yield curve to steepen further into the second half of 2021 with an improving growth outlook. Any downturn in economic growth or slowdown in the reopening of the economy would drive long-term rates lower amid renewed demand for safe-haven assets. However, with interest rates at very low levels and the worst of the downturn behind us, we believe that investors should be positioned for long-term rates to continue to move higher.

In an environment characterized by rising interest rates, investors should take an active approach when investing in fixed income as selectivity will become even more important going forward.

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