Key Questions

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Why Are Interest Rates Surging? When Will They Peak? What Should Investors Do?

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In late 2021, when short-term interest rates stood near zero and long-term interest rates hovered around 1.5%, Jay Powell, Chairman of the Federal Reserve (the Fed), announced that he no longer viewed inflation as transitory. As a result, interest rates would have to be lifted to get inflation under control.

In our view, that was an appropriate stance to take. Importantly, however, as we noted at the time, Chairman Powell and his Fed colleagues were six-plus months too late: Inflation had surged from less than 2% at the beginning of 2021 to nearly 8% by the end of the year. Consequently, for much of 2022, the Fed, tacitly acknowledging it was behind the curve, endeavored to arrest inflation by raising interest rates at unparalleled speed and by an unparalleled amount. This trend continued into the first quarter of 2023.

There is an old investment adage that states, “The Fed tightens until something breaks.” In other words, because the Fed’s inflation-fighting tools are fraught with uncertainty as measured both by the timing and the magnitude of their impact, the Fed typically over-corrects and raises interest rates too high and/or too fast. This typically triggers troubles within the financial system that usually spill over into the broader economy.

By March 2023, the Fed had raised short-term rates by 500 basis points (5%), an astonishing amount in such a short period of time. At the same time, long-term rates (which are set by market forces, not the Fed) rose roughly half that amount, or 250 basis points (2.5%).

There is much that could be said about the difference between short-term interest rates and long-term interest rates, but we’ll refrain from discussing this here. Instead, we will describe what happened next, for this better explains why things are where they are today.

In March 2023, a few sizeable financial institutions faced a barrage of funding pressures (stemming from balance sheet pressures caused by the rapid rise in interest rates), ultimately causing them to close or be assumed by larger, better-capitalized institutions. [Cue the sound of glass breaking.]

Since then, short-term rates have remained roughly unchanged. Yet, longer-term rates have swiftly climbed at the same time that inflation has moderated. So, why are longer-term interest rates surging? Several forces are responsible.

First, there is renewed focus on government deficits coupled with the cost to finance these deficits. Interest payments for the US government are expected to exceed $1 trillion annually, a staggering sum. Relatedly, in order to fund its obligations, the federal government must issue new bonds, causing supply to increase. This, in turn, is prompting investors to demand higher interest rates as new bonds come to market.

Additionally, the Fed’s continued fight against inflation has

caused some market participants to conclude that rates will need to remain "high for longer," at the same time that other central banks are engaged in a fight against inflation as well.

But perhaps the biggest factor behind the jump in long-term interest rates stems from the fact that the US economy continues to perform better than expected, with strength seen in several key areas. Most notably, consumer spending, which accounts for more than two-thirds of the US economy, has been rising faster than expectations.

Looking ahead, it is possible (perhaps even probable) that interest rates could move higher in the near-term. Geopolitical risks exist on multiple fronts, with ongoing wars in the Middle East and Eastern Europe while tensions between the US and China persist. This dynamic creates tremendous uncertainty and could ignite a new spark of inflation with little warning. Moreover, if congressional gridlock worsens from an already elevated level, it could prompt greater concerns over the aforementioned federal budget deficits and push interest rates higher still.

On the other hand, should the labor market weaken or consumer spending moderate, interest rates may begin to ease. Neither appears imminent in the short run, however, as consumers' savings begin to diminish; some moderation should materialize later this year, or in the first half of 2024.

What should investors do?

Over the last few years, some fixed-income investors have elected to invest in the very short end of the interest rate curve (maturities of 2 years or less), rolling proceeds into new bonds once their old ones mature. This has been an effective strategy, as they have recently been able to roll into higher yields.

For those sitting on the sidelines and potentially accumulating excess cash, we believe it may make sense to consider deploying some cash into slightly longer duration fixed-income instruments. Bonds maturing between 5 and 10 years are especially attractive at the time of this writing. High-quality corporate bonds are also compelling, and for investors in the top tax brackets, municipal bonds can offer useful diversification to one's overall portfolio while locking in some higher income streams in the process.

More specifically, some municipal bonds, including those that are highly rated, are yielding 5%, a level that has historically lured investors off the sidelines. An investor in a 37% tax bracket who invested in a municipal bond would earn a taxable equivalent yield of nearly 8%, a comparable return with stocks but with a considerably lower risk profile. These returns are based on a 30-year bond, which is among the longest duration most investors consider, and its price is more susceptible to fluctuations in interest rates. However, because stocks are also often viewed as long-duration assets, the comparison is valid.

In short, while the spike in bond yields has potentially led to unrealized losses for some investors, it has created an environment where attractive yields in municipal bonds and other fixed-income securities are again apparent. Selectivity and diversification are still of paramount importance. But there is income in fixed income again, and investors should take note. Interest rates may continue to rise in the short-term, but higher bond yields can lead to higher returns in the long run.

For more information, please contact your advisor.

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