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Market Observations
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ON THE RISE

Interest rates are on the rise in the U.S. The era of extremely low yields that arose in response to the Great Recession appears at an end. Central banks around the world including the U.S. Federal Reserve ("Fed") have been carefully assessing appropriate policies in light of rates of growth and inflation for their respective economies. Higher rates are good news for savers and lenders but less so for borrowers and current bondholders. A review of global interest rates and inflation can provide perspective.

Perspective

With stronger growth and higher inflation, the Fed is leading other central banks in a directional change of monetary policy. The current level of U.S. short-term interest rates results from seven steps implemented by the Fed starting in late 2015. Table I shows comparative yields for U.S. Treasury securities of various maturities along with rates of inflation. Current yields for all maturities are meaningfully above historical lows but well below historical averages let alone prior highs. As is typical of a rising interest rate period, yield increases for shorter term maturities outpace those for longer term maturities. The result is a lower return advantage for taking the price risk of holding longer maturities.

Here is the challenge for monetary policy: too high an interest rate suggests policy is restrictive, leading to lower real growth and inflation; too low a rate suggests policy is accommodative, leading to higher real growth and inflation. The rate to be monitored is one adjusted for inflation and taxes. A proxy is shown in Chart I. The inflation rate is the Consumer Price Index. The tax rate is the top corporate tax rate. A 0% after-inflation-and-tax yield suggests an equilibrium. In spite of the recent increase in yields, this measure indicates that Fed policy remains quite accommodative.

U.S. interest rates are influenced as well by yield levels in other countries. Investors look to optimize after-inflation-and-tax returns globally. Table II compares current yields and inflation for major developed countries. Higher relative inflation suggests that U.S. rates should be relatively higher as well. At the same time, yield and inflation differentials between the U.S. and these other countries imply stronger foreign demand for U.S. bonds and a potential limit to the rise in U.S. bond yields.

Investment Implications

Any adverse impact of higher interest rates on investment outcomes could be better managed if the rise is orderly. Not even the Fed can guarantee this outcome. As a result, portfolio management must be approached with a disciplined process to address the many uncertainties of investing, including the future level of interest rates.

TABLE I

U.S TREASURY YIELDS & INFLATION

MATURITY	LAST MONTH END	HISTORICAL HIGH	HISTORICAL LOW	HISTORICAL AVERAGE
THREE MONTHS	2.0%	16.1%	0.0%	4.5%
ONE YEAR	2.4%	17.0%	0.1%	5.2%
TWO YEARS	2.7%	16.7%	0.2%	5.4%
THREE YEARS	2.8%	16.5%	0.3%	5.6%
FIVE YEARS	2.9%	16.3%	0.6%	5.9%
TEN YEARS	3.0%	15.8%	1.5%	6.2%
THIRTY YEARS	3.1%	15.2%	2.2%	6.5%
12-MONTH CPI	2.9%	14.6%	-2.0%	3.6%

CHART I

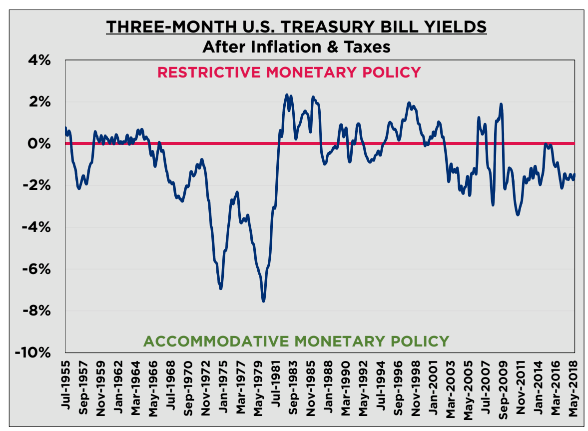

TABLE II

GLOBAL GOVERNMENT YIELDS & INFLATION

COUNTRY	MATURITY: THREE MONTHS	MATURITY: TEN YEARS	INFLATION
AUSTRALIA	2.2%	2.6%	2.1%
CANADA	1.8%	2.2%	2.5%
GERMANY	-0.3%*	0.3%	2.1%*
JAPAN	-0.1%	0.0%	0.7%
SWITZERLAND	-0.7%	-0.1%	1.2%
UNITED KINGDOM	0.7%	1.4%	2.4%
UNITED STATES	2.0%	3.0%	2.9%

*Eurozone