Money Talks by Dave Helscher

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I recently attended a meeting of the state trust association. During a break we were discussing the recent moves in interest rates. A young trust officer shared his grandparents' stories of high rates in the early 1980s. Grandparents!! I informed him and the group that I was working in the industry during that time. The look on his face was either one of awe or maybe just sympathy. But to many investors 40 plus years ago is a long time ago.

The recent run up in long-dated Treasury yields has caught many investors, including my younger colleagues, and the Federal Reserve's attention. The yield on the ten-year U.S. Treasury rose from 4.1% at the end of August to a recent 4.9%. Many investors have only known historically low interest rates, near 0% for most of the past 15 years. The Federal Reserve has engaged in a series of short-term interest rate hikes for the past year and a half in an effort to tame inflation. Fed Funds have risen 5.5% over that time period and futures markets are predicting another quarter point increase prior to year-end. The Federal Reserve Open Committee (FOMC) has two more scheduled meetings this year, one in early November and another in December. In addition to the Fed's efforts to rein in inflation by raising rates, the fixed income markets have moved over the past two months so that yields are providing an assist to the Fed's actions.

The higher for longer rate outlook has been communicated by the FOMC since summer, but it seems to have been taken seriously only recently. The latest projections from the FOMC have poured cold water on expectations for significant rate cuts next year. Inflation remains above the Fed's target of 2%. The impact of Fed actions has not been felt by many borrowers. Many home owners locked in low mortgage rates and have little reason to re-finance higher rates. Consumers continue to spend but may not be aware of rising rates on credit card rates. Most corporate debt will not be due for several more years. Owners of older vehicles have not acquired newer vehicles due to sticker shock and the higher costs of auto financing.

The markets had been forecasting four rate cuts next year but after the latest FOMC meeting, the Fed is signaling an intent to hold interest rates higher for longer. This is a reaction to a U.S. economy that is grudgingly slowing. Inflation is significantly off its highs but still above the Fed's target. Jobs openings remain robust, initial jobless claims are low, and the consumer continues to spend based on the latest retail sales figures. Headwinds are building in the economy: rising oil and gas prices; struggling Europe and China; resumption of student loan payments; exhaustion of accumulated excess savings; and higher rates on home mortgages and credit cards. These headwinds are yet to be fully reflected in current data so the Fed has paused. Investors have been reluctant to buy longer dated maturities if they will be able to get higher yields if patient.

There are additional factors in play. The Federal Reserve has been reducing its balance sheet, from $9 trillion in April 2023 to about $8 trillion now. The Fed is allowing monthly maturities to roll off their balance sheet, meaning its not reinvesting maturities in new treasury issues. This has reduced demand but not supply, causing bond prices to decline and yields to move higher. This shift in monetary policy has yet to be fully felt in the economy.

You may recall the Congressional debate over the debt ceiling several months ago. A deal was struck but it did not fully restore bond market confidence. The last-minute continuing resolution to fund the federal government for 45 days did little to asway concerns of fiscal policy. The clock is ticking until the new budget deadline and the current lack of a Speaker and inability for the House of Representatives to take action has compounded these concerns. To many investors, this indicates a forecast of continuing growing national debt and deficits, making U.S. sovereign debt less attractive at current prices.

A market as large and as liquid as the U.S. sovereign debt market is subject to a host of global events. The recent crisis in the Middle East saw a flight to the perceived safety of U.S. debt. This has been the usual case over the past 40 years, events occur and investors seek safety. The underlying factors and actors do change, but as most grandparents will agree, the one constant is change.