Project Syndicate

US Interest Rates Will Continue to Rise
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CAMBRIDGE – Six months ago, I wrote that long-term interest rates in the United States would rise, causing bond prices to fall by so much that an investor who owned ten-year Treasury bonds would lose more from the decline in the value of the bond than he would gain from the difference between the bonds' interest rate and the interest rates on short-term money funds or bank deposits.

That warning has already proved to be correct. The interest rate on ten-year Treasury bonds has risen almost a full percentage point since February, to 2.72%, implying a loss of nearly 10% in the price of the bond.

But what of the future? The recent rise in long-term interest rates is just the beginning of an increase that will punish investors who are seeking extra yield by betting on long-term bonds. Given the current expected inflation rate of 2%, the real rate on ten-year bonds is still less than 1%. Past experience implies that the real rate will rise to at least 2%, taking the total nominal interest rate to more than 4%, even if expected inflation remains at just 2%.

The interest rate on long-term bonds has been kept abnormally low in the past few years by the Federal Reserve's "unconventional monetary policy" of buying massive amounts of Treasury bonds and other long-term assets – so-called quantitative easing (QE) – and promising to keep short-term rates low for a considerable period. Fed Chairman Ben Bernanke's announcement in May that the Fed would soon start reducing its asset purchases and end QE in 2014 caused long-term interest rates to jump immediately. Although Bernanke's announcement has focused markets on exactly when this "tapering" will begin and how rapidly it will proceed, these decisions will not affect the increased level of rates a year or two from now.

The promise to keep the overnight interest rate low for an extended period was intended to persuade investors that they could achieve higher returns only by buying long-term securities, which would drive up these securities' prices and drive down their yields. But the current version of this promise – not to raise the overnight interest rate until the unemployment rate drops below 6.5% – no longer implies that short-term rates will remain low for an "extended" period.

With the unemployment rate currently at 7.4% – having fallen nearly a full percentage point in the last 12 months – markets can anticipate that the 6.5% threshold could be reached in 2014. And the prospect of rising short-term rates means that investors no longer need to hold long-term bonds to achieve a higher return over the next several years.

Although it is difficult to anticipate how high long-term interest rates will eventually rise, the large budget deficit and the rising level of the national debt suggest that the real rate will be higher than 2%. A higher rate of expected inflation would also cause the total nominal rate to be greater than 5%.

Today's investors may not recall how much interest rates rose in recent decades. The interest rate on ten-year Treasuries increased from about 4% in the mid-1960's to 8% in the mid-1970's and 10% in the mid-1980's. It was only at the end of the 1970's that the Fed, under its new chairman, Paul Volcker, tightened monetary policy and caused inflation to fall. But, even after disinflation in the mid-1980's,

long-term interest rates remained relatively high. In 1985, the interest rate on ten-year Treasury bonds was 10%, even though inflation had declined to less than 4%.

The greatest risk to bond holders is that inflation will rise again, pushing up the interest rate on long-term bonds. History shows that rising inflation is eventually followed by higher nominal interest rates. It may therefore be tempting to invest in inflation-indexed bonds, which adjust both principal and interest payments to offset the effects of changes in price growth. But the protection against inflation does not prevent a loss of value if real interest rates rise, depressing the value of the bonds.

The relatively low interest rates on both short-term and long-term bonds are now causing both individual investors and institutional fund managers to assume duration risk and credit-quality risk in the hope of achieving higher returns. That was the same risk strategy that preceded the financial crisis in 2008. Investors need to recognize that reaching for yield could end very badly yet again.

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