Will interest rates rise, fall, or hold steady?

What are interest rates going to do? Rise, fall, or hold steady? Efforts to predict future interest rates is a fool's errand. But yet, it remains a necessary task. How do we square these two contradictory real-world observations?

HISTORY

The future is inherently unknowable. Yet we have over 200 years of U.S. economic and interest rate history to examine and learn from. Even better, we have over 2,000 years of global economic and interest rate history. An understanding of this history allows us to understand (and do so with great rigor and considerable depth) how economies and interest rates work, i.e., why they do what they do.

TODAY

We overlay this understanding (of the "way things work") with the facts describing where our economy stands today . . . the balances, imbalances, and the forces at play. Taken together, our understanding of past relationships and current day circumstances, allows us to draw strong, robust, and quite useful conclusions of what future interest rates are most likely to look like.

WHAT CAN WE CONCLUDE

Does this understanding allow us to make the exact right investment decisions at the exact right time? Not a chance! A healthy dose of humility must be brought to the table.

However, if we continuously update (and change) our conclusions as new data arrives, maintain a balanced perspective, and apply an extra dose of humility . . . then, we can draw some powerful and useful investment conclusions about how best to structure bond (fixed-income) portfolios.

A HUMBLE PERSPECTIVE

So, based on historical relationships and current day realities, what does the current-day analysis say about the future of interest rates?

After adjustment for inflationary expectations, the current yield on the 10-year U.S. Treasury bond (as of April 9th) is 1.12%. This is what you will earn over the next 10 years after inflation is subtracted out. Is 1.12% a fair and reasonable annual return? Well, the long-run average is 2.4%. So, today's current yield is -53% less (proportionately) than what is typical or normal. That's a pretty BIG deal, and suggests that interest rates need to rise quite a bit more.

But what is normal and typical? Consider actual history . . . it tells us . . . think "*shock and awe*".

Integrated Financial Partners, Inc.
200 Fifth Avenue, Suite 4010 • Waltham, MA 02451
Phone 781-890-3045 • Website https://integrated-partners.com/

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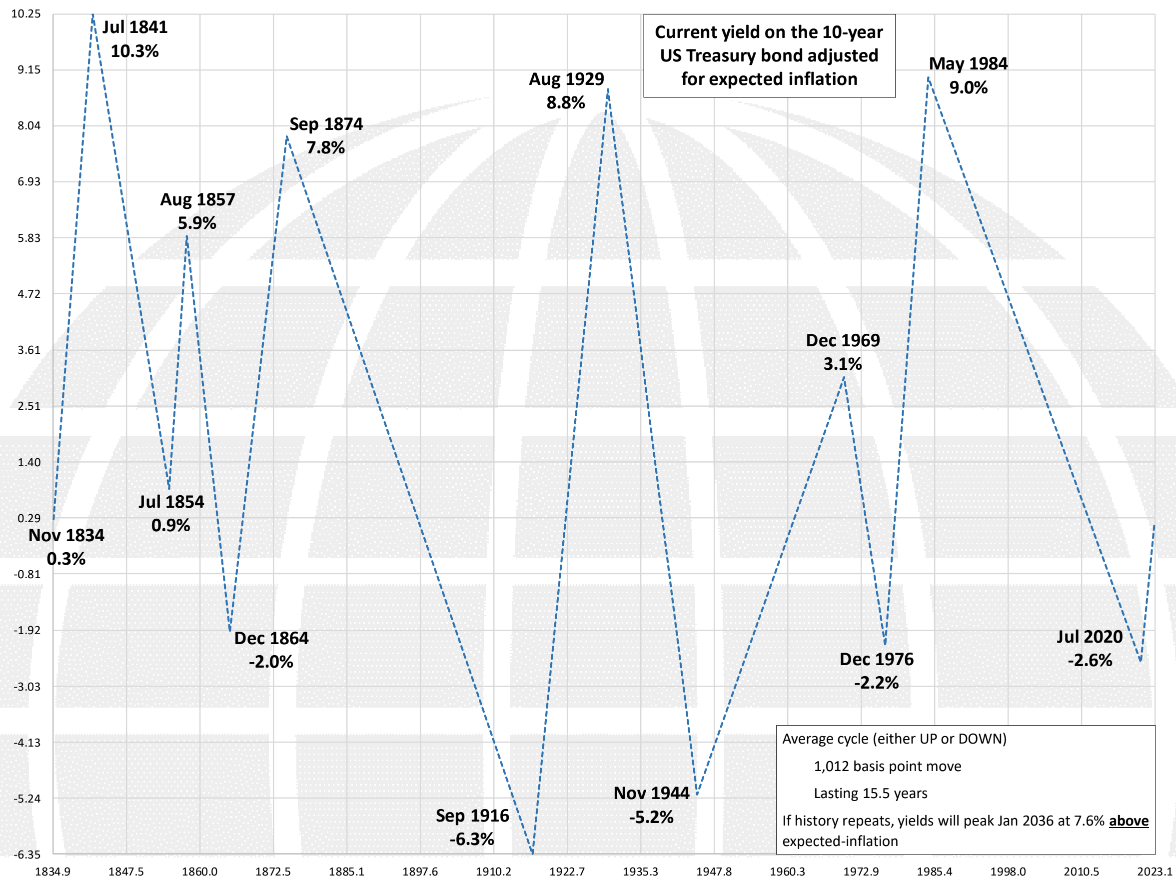

Since 1834, the average yield has been 2.4%. Although accurate and correct . . . that would be the WRONG takeaway from this quite accurate graph. The all-important observation is that interest rates are never static, much less stable. Instead, they're always rising or falling . . . by a lot . . . and over decades, not years. Such large and long-lasting moves have been the defining element. And these "mega-moves" didn't happen by accident, instead they unfolded for quite solid reasons.

We just completed a 35- to 40-year era of falling interest rates (approximately 1984 to 2020). That made investing seriously easy. Unless history now follows a path that it never has before, interest rates will rise for another decade or two.

If such an expectation comes to pass, would it follow a straight line, ever upward? Absolutely not. Interest rates have always experienced minor ups and downs. At some point, the U.S. will experience an economic recession. This is normal and healthy (rejoice). During the coming recession, interest rates are likely to fall (can we say this with certainty? No! But falling interest rates are the most likely scenario, and by a fairly wide margin).

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But after interest rates decline (as a result of the imminent recession), they are expected to rise . . . resuming their anticipated upward trajectory spanning a decade or two or three. The prudent question becomes: "*But why? Why must interest rates rise? What are the forces that would push them ever higher?*"

Nothing ever happens by chance. There is always causality. So, what might the drivers be that would push interest rates up for an additional 10 to 20 years?

- **First** - Interest rates are too low today. They need to at least return to average.
- **Second** - We and the rest of the world have embarked upon (or embraced) a series of seriously expensive mega "*projects*". You and I might "like" or "dislike" these "*projects*" . . . but our preferences don't change the reality that they are progressing:
  - Hot war with Russia
  - Cold war with China . . . hopefully staying cold
  - Conversion from fossil fuels to renewables
  - Income inequality gap . . . think wages rising by a lot and for a very long period of time
  - Wealth inequality gap
  - Expanding social welfare programs
  - Transitioning from one political structure . . . to a different structure
  - Deglobalization

  Inflation is an effective method for both obscuring the cost of these "*projects*" . . . and dispersing their economic burden

SO, WHATS TO BE DONE

Rising interest rates are **NOT** a bad thing . . . so long as they don't rise too fast. But having interest rates rise for another decade or two or three is a powerful thing. It affects what stock and bond portfolios are most likely to do well (as opposed to do poorly).

Your financial advisor has a menu of possible investment solutions that are directly relevant to the issues discussed above. But the solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

Rob Brown, CFA, PhD
Chief Investment Officer
Senior Vice President
Integrated Financial Partners, Inc.
Integrated Wealth Concepts, LLC
Integrated Family Office

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All data was provided by Global Financial Data, Inc. on April 9, 2023.

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