



# Fort Washington Investment Advisors, Inc.

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## The New Debate: Does Massive Stimulus Portend Higher Interest Rates?

- **Markets Are Normalizing**
- **The Second Half Outlook: It's the Economy, Stupid!**
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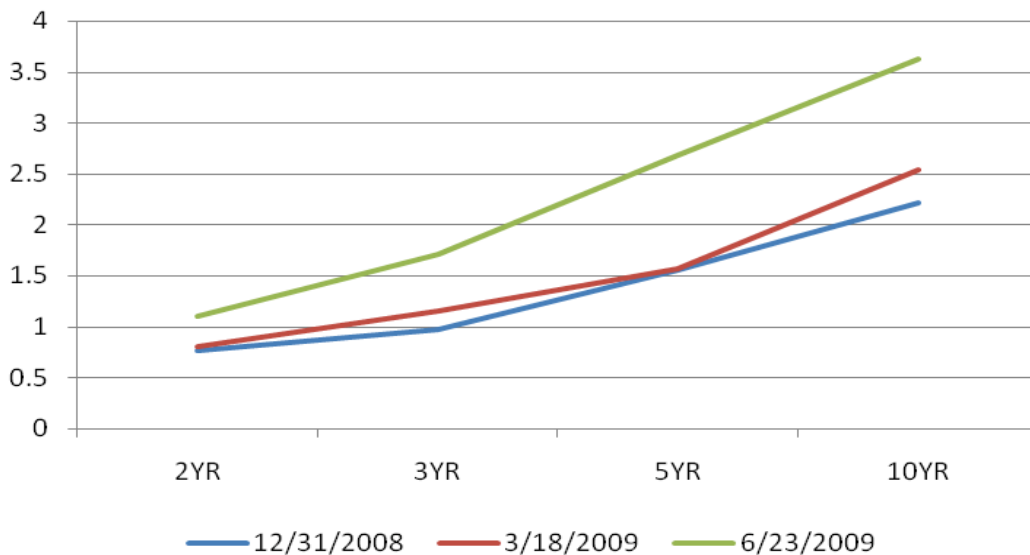
## The New Debate: Does Massive Stimulus Portend Higher Interest Rates?

We are often struck by the speed and power of market movements, especially when a sea-change in expectations is occurring. Earlier this year, many investors had lost confidence in policymakers' ability to stabilize the banking system, and some feared the global economy could be headed for a bout of deflation. Indeed, at the lows in early March, the cumulative decline in the U.S. stock market was rivaling that of the early 1930s. However, these fears have faded in recent months, as equities and other risk assets have rallied considerably.

Investors now are wondering whether massive fiscal and monetary stimulus will prove to be too powerful. These concerns have been bolstered by a spike in treasury yields of more than 100 basis points since mid-March, when the Fed launched its program to buy long-dated treasuries and mortgage-backed securities (see Figure 1). This development, in turn, has sparked a lively debate among economists and market commentators about the outlook for inflation and interest rates.

Figure 1

### Treasury Yields Have Shifted Upward



Source: Bloomberg

The debate encompasses several issues: (i) What forces are contributing to the rise in treasury yields? (ii) Does the back-up in rates pose a threat to economic recovery, and how will policymakers respond? (iii) Are higher inflation and interest rates the inevitable outcome of unprecedented policy stimulus?

Following is our assessment of these issues:

- *Treasury yields are being driven primarily by expectations that economic conditions are normalizing.* While inflation expectations have increased from low levels, the bond market currently is pricing inflation to stay around the 2%+ trend rate of the past decade.
- *The key driver of treasury yields in the balance of this year will be the pace of economic recovery.* We do not expect the Federal Reserve to try to drive treasury yields down unless recovery is in jeopardy.
- *Over the longer term, massive budget deficits and the need for the Federal Reserve to drain excess liquidity point to much higher treasury yields.* The main uncertainty is whether the Fed will be able to contain core inflation in the 2%-3% range. If not, long-term yields eventually could surpass the 7% threshold last reached in the mid-1990s.



## Markets Are Normalizing

After falling to record lows in 2008, the treasury yield curve has shifted upward significantly this year while also steepening. Long-term treasury yields have risen by about 150 basis points, and the 10-year yield and long bond yield temporarily reached 4.0% and 4 ¾%, respectively. Until recently, the yield on the two year note was anchored below 1%. However, it increased by nearly 50 basis points in early June, as market participants began to price in a Fed rate hike late in 2009 or early in 2010.

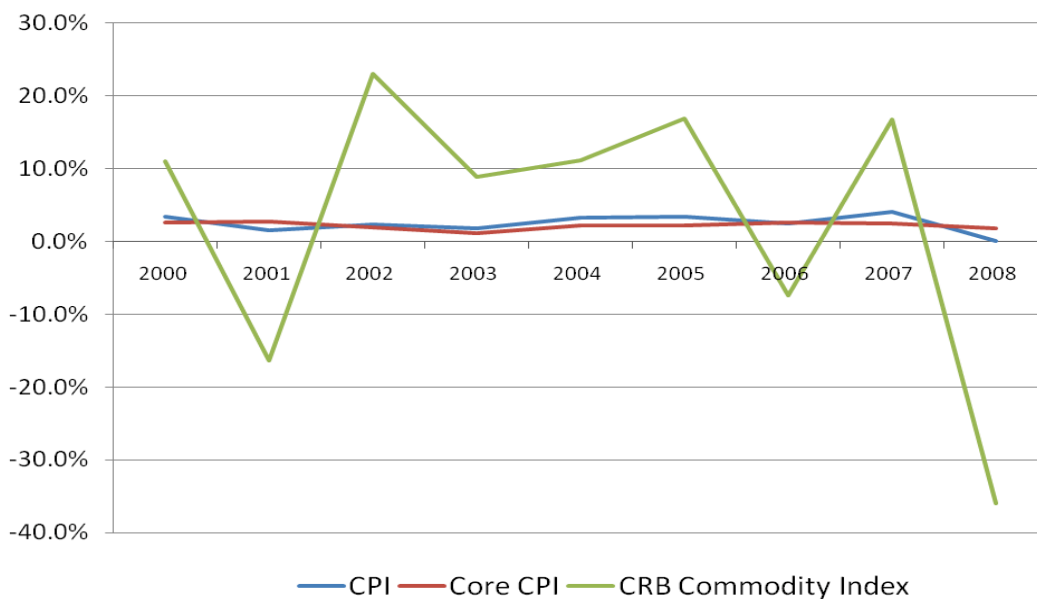
The back-up in treasury yields has occurred while assets across the risk spectrum – investment-grade corporate bonds, high yield bonds, equities and emerging market instruments -- have rallied significantly. These market moves have one common explanation: namely, investors believe the threat of financial collapse and deflation has diminished and the U.S. and global economies are stabilizing. Accordingly, the flight to quality that occurred following the collapse of Lehman Brothers is being unwound.

Inflation expectations have also increased somewhat in the United States after having been virtually dormant at the beginning of this year. Long-term inflation expectations embedded in TIPS spreads currently are about 2%, which is the trend rate of consumer price inflation over the past decade. Government bond yields in Europe also have moved in tandem with treasuries, even though inflation is perceived to be better contained there.

Some observers point to rising oil and commodity prices and a weaker dollar as harbingers of accelerating inflation. However, because commodity prices are extremely volatile, they may not be an accurate guide to trends in consumer price inflation (see Figure 2). Our own take is that an imminent rise in inflation is unlikely, especially with the U.S. economy headed for 10% unemployment and the rate of capacity utilization below 70%. That said, we believe there is greater risk of rising inflation over the longer term, and a heavy supply of treasury paper will weigh on the market.

Figure 2

### Commodity Prices and Consumer Price Inflation



Source: Bloomberg

CPI = Consumer Price Index

Core CPI = Consumer Price Index, excluding energy and food prices

CRB Commodity Index = Reuters/Jefferies Commodity Research Bureau Index



## The Second Half Outlook: It's the Economy, Stupid!

Meanwhile, the path of treasury yields over the balance of this year will be dictated largely by the pace of economic recovery. Should the economy experience a typical V-shaped rebound, yields could rise further, possibly to 4.5% for the ten year benchmark. Such an outcome would also likely result in a further increase in short-term yields, as investors would price in a greater likelihood of Fed tightening by early 2010.

The more probable outcome, however, is that recovery will prove to be sub-par. In that event, long-term treasury yields may settle around current levels, but the yield on short-term treasuries may ease, as investors come to believe the Fed is on hold indefinitely. Our assessment is based on several considerations. First, while credit market conditions are improving, they still are not functioning normally, and the U.S. economy is very sensitive to credit availability. Second, a catalyst is missing that will cause households to boost their spending significantly, especially when unemployment is headed for 10%, wage increases are modest and considerable wealth has been destroyed. Increases in oil prices, moreover, will act as a tax on households and lessen their ability to spend on other items.

Finally, the main circumstance in which the Federal Reserve might attempt to drive treasury yields lower would be if recovery were to be in jeopardy. Based on reports from the financial press, Fed officials view the back up in treasury yields thus far as benign and take comfort from the narrowing in corporate and high yield credit spreads. The main area of concern is the mortgage market, where rates have backed-up significantly in the recent weeks. However, Fed officials have made it clear that their primary objective is an improvement in the overall economy rather than the housing market specifically.

## Long Term Trends Are Worrisome

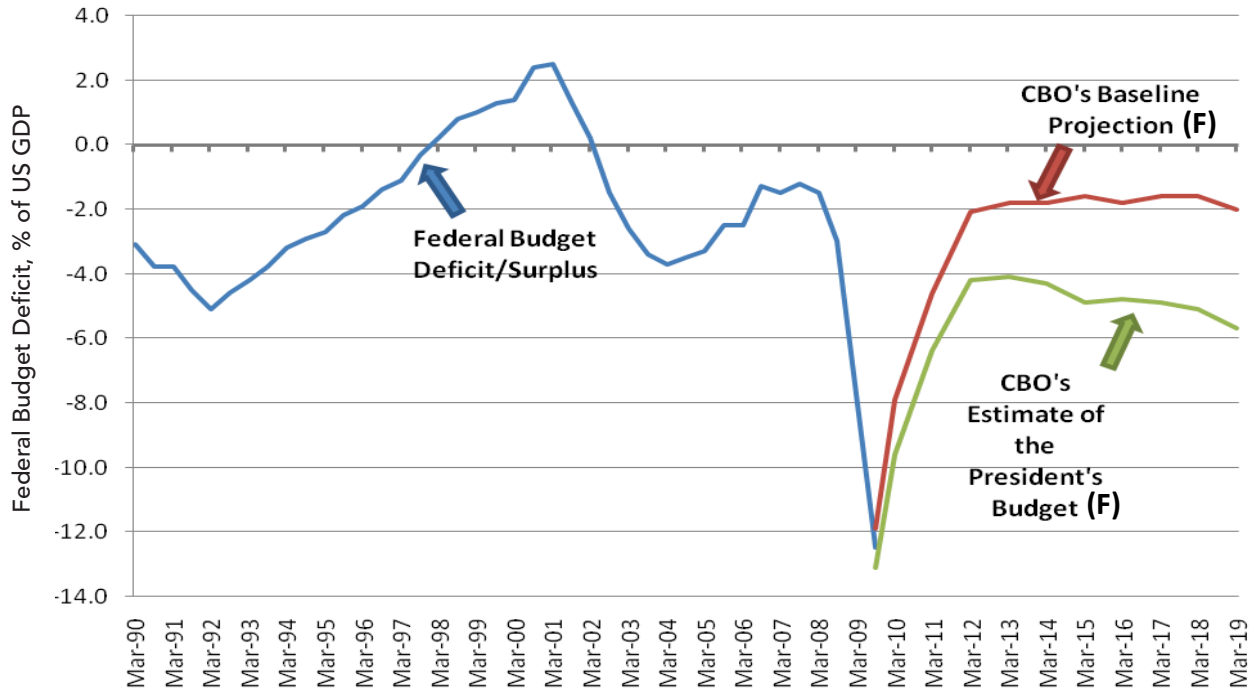
While the near term outlook for inflation and interest rates is fairly benign, we are more concerned about the long-term outlook. It is one thing for the federal government to run a massive budget deficit of 13% of GDP temporarily while the economy is in severe recession. The problem, however, is that the deficits are now projected to remain at high levels throughout the coming decade even if the economy grows at a healthy pace.

The latest projections by the Congressional Budget Office (CBO), for example, call for budget deficits to average 5.5% of GDP in the coming decade (see Figure 3). By 2019, the federal debt burden will have doubled to 82% of GDP, reaching more than \$17 trillion, roughly triple the 2008 level. An increase of this magnitude poses a risk that it could undermine investor confidence, especially on the part of foreign investors such as China, who already have large holdings. (Standard & Poor recently indicated it could lower the AAA rating for the U.K. government for similar reasons.) Also, continued large budget deficits would put upward pressure on interest rates that could "crowd out" business investment at some point.



Figure 3

CBO projections of the Federal Budget Deficit



Source: Bloomberg, Congressional Budget Office  
F= Forecast

Massive budget deficits by themselves are not necessarily inflationary, provided the Federal Reserve does not monetize them. This lesson was learned in the first half of the 1980s, when the U.S. government began to run annual budget deficits of 3% to 5% of GDP. While many observers worried about accelerating inflation then, the Federal Reserve under Chairman Paul Volcker was determined to reduce inflation and inflationary expectations. Instead of targeting the federal funds rate, U.S. monetary policy targeted the level of bank reserves and money supply growth. The mix of an expansionary fiscal policy and a tight monetary policy initially resulted in record high interest rates, but bond yields eventually declined as inflation expectations diminished.

The conduct of monetary policy today is the opposite of that in Volcker era. The Fed's current strategy of credit easing is directed at keeping the funds rate near zero by supplying ample liquidity to financial institutions. The increase in bank reserves is not inflationary now, because banks are content to hold excess reserves (beyond those needed to fulfill reserve requirements). As recovery begins to take hold and loan demand picks up, however, the Fed will need to drain the excess liquidity, or risk higher inflation.

While officials understand what is at stake, investors are understandably nervous about how effective the Fed will be in managing this transition. In fact, some commentators blame the Federal Reserve for failing to tighten monetary policy in time to avert the bubble in housing prices, and they fear the Fed will act too slowly in the current environment. For our part, we believe it is too early to form such a judgment, although we acknowledge the challenge the Fed faces is daunting.

Our bottom line is that the trajectory for treasury yields is significantly higher over the next few years due to massive treasury supply and potentially higher inflation. If the Fed is successful in keeping core inflation between 2%-3%, long term treasury yields eventually could reach 6%-7%. However, if inflation accelerates beyond this range, we would adjust our forecast range commensurately higher. With foreign investors already wary about ballooning budget deficits, the U.S. Government would be well advised to rein in the deficits in outlier years before investors lose confidence.



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