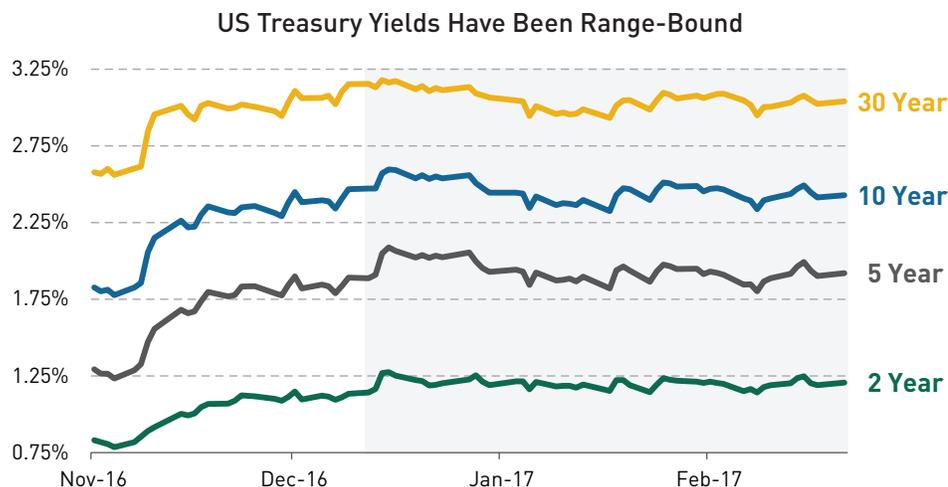


# Even If Rates Rise, They're Unlikely to Wander Out of Range in the Long Run

The election of Donald Trump and the Republican sweep of Congress immediately sparked optimism within financial markets. Equity indexes and Treasury yields rose with the expectation that fiscal stimulus and economic reforms would contribute to an increase in growth, and possibly, inflation. Since December, interest rate volatility has been in steady decline and Treasury yields have been range-bound, while equity markets continue to set new highs.

On the surface, the recent sideways trend of Treasury yields may give the impression of a relatively benign interest rate environment. However, in our view, it is the product of a growing divergence between offsetting bullish and bearish views of the global economy, geopolitical landscape, and monetary policy.

Still, we believe that rates are likely to remain range-bound further out along the yield curve, regardless of whether the Federal Reserve raises them in the next few months, while the front end of the curve would be more at risk of rising along with Fed rate hikes.



Source: Bloomberg and PineBridge Investments. As of 21 February 2017.

## The case for higher rates

Across all of the group of four (G4) economies – the US, European Union (EU), UK, and Japan – economic activity is trending higher. In the US, manufacturing surveys, retail sales, wage growth, and small business confidence all recently hit multiyear highs. Twelve months ago, concerns about the future of China's economy were fueling bear markets. Today China's economy appears stable, and its growth is helping support a recovery in commodity prices. This has been a major contributor to the increase in headline inflation rates (i.e., total inflation) across advanced economies, particularly the US and Europe.

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On average, economic data have been beating expectations for G10 economies.

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Source: Citi, Bloomberg, and PineBridge Investments. As of 21 February 2017.

After years of dependence on monetary policy to support economic growth, investors have embraced the possibility that the US now appears poised to rely on fiscal stimulus and economic reform instead. The potential addition of tax cuts, infrastructure spending, repatriation of corporate cash held overseas, and relaxed regulation to an economy that already appears to be more robust supports the belief that higher growth rates, inflation, and interest rates are likely to continue.

The Fed, for its part, has not distanced itself from this view, maintaining its forecast of three rate hikes in 2017. Recent statements from Fed Chair Janet Yellen and several Federal Open Market Committee (FOMC) voting members appear unified in their hawkishness, further bolstering the argument that the US economy can indeed support higher rates this year.

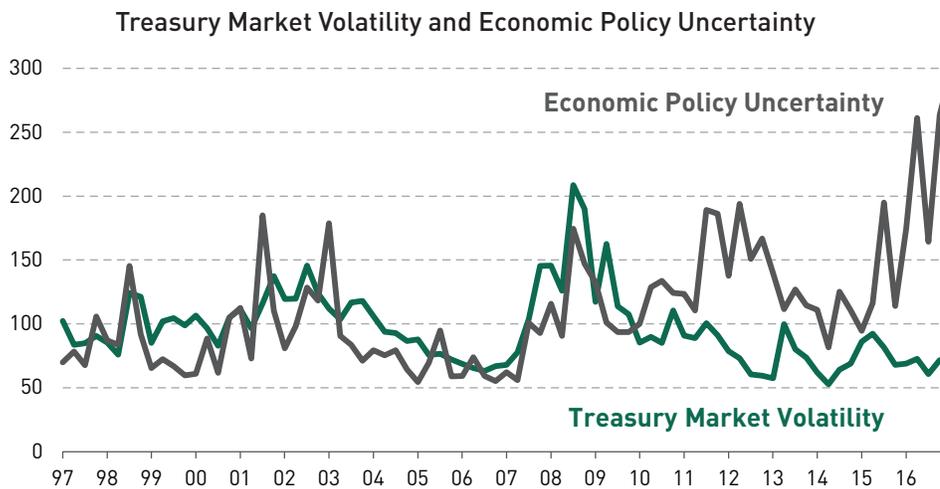
## The case for lower rates

The first risk that threatens the bullish economic outlook is political uncertainty. Following a year in which voters rejected the political establishment in major elections in both the UK and US, the 2017 political calendar features several elections that could alter the fate of the European Union. The Dutch go to the polls in March, followed by two rounds of French balloting in April and May, with the possibility of an Italian election later in the year. The rise of anti-establishment, populist movements in all three countries presents a significant risk to the future of the eurozone, the euro currency, and the stability of financial markets globally. Although the probabilities are low, the mere prospect of political upheaval should keep a lid on rates globally until the election calendar is cleared. In the case of Italy, that's not likely to occur until the third quarter of 2017 at the earliest.

Unfortunately, political risk is not confined to Europe. In the US, President Trump's aggressive pursuit of many of his campaign pledges has solidified partisan opposition and even led to some dissension within the ranks of his own party, which will challenge his ability to pass many of the reforms that are a key

component of the bullish case scenario for US growth. In addition, the extent to which the new administration will move to restrict global trade remains unclear. Passing tariffs that could provoke a trade war would cause global growth to stagnate.

Finally, although the topic of Brexit has faded from the headlines, the implications of the UK's exit from the EU on the global economy have yet to be determined. European elections, the unpredictability of US policy, and Brexit have contributed to a rise in global economic policy uncertainty and represent risks that could potentially lead to a decline in Treasury yields.



Source: BAML, Baker, Bloom & Davis, Bloomberg, and PineBridge Investments. As of 21 February 2017.

Treasury market volatility has belied growing economic policy uncertainty.

For all the talk of fiscal stimulus and economic reform in the US, the fact remains that the country's extraordinarily high public sector debt has made the economy quite sensitive to changes in monetary policy. It is with this in mind that we continue to count monetary policy error, in the form of an overly aggressive Fed, as one of the leading risks to the economic outlook for both the US and the world. Although the recent uptick in headline inflation has raised concerns, much of the acceleration can be attributed to the year-on-year base effect of higher oil prices, as core inflation has actually trended lower over the past 12 months.

## Keep calm and carry on

The risks that are underpinning the current range-bound Treasury market are not only divergent but also appear to be of substantial magnitude, which explains the wide range of alarmist opinions that may adversely affect an investor's ability to make decisions in today's environment. Still, we feel confident that rates will remain range-bound further out along the curve even if the Fed raises them in the next few months, with the 10-year Treasury yield trading between 2.3% and 2.6%. Longer term, while the upside risks among advanced economies have grown, we still feel comfortable in our view that the relatively low-rate environment will continue.

## About

## PineBridge

## Investments



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