Northern Trust | Lowering Expectations for Interest Rates

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While the recent bond market rally came fast and furious, and is probably due for some profit taking, we think lower rates are here to stay over a longer term horizon.

We actually just lowered our expectations for the US treasury 10 year yield, and now think the Fed will cut rates later this year. Let me tell you why.

When the Fed makes decisions on what to do with interest rates, they often look at two things-- momentum in the economy and inflation. Let's start with economic momentum.

We're looking at a slowdown. In the fourth quarter last year, US growth was weaker than investors expected, which we think will set the pace for the rest of this year. Next year, the Federal Reserve and other forecasters see US growth falling to about 2% and we agree.

As for inflation, it's missing in action around the world, below the target set by central banks. As a result, 10 year yields in Japan, Switzerland and Germany are all negative or near zero, and the US bond market has rallied. We now expect the US 10 year Treasury yield to trade between 2% and 2.5% over the next six months, down from our previous range of 2.5% to 3%.

We think the Federal Reserve made a mistake with its last two rate hikes, and will be forced by the market to reverse at least one, if not both, of these mistakes. As slower growth kicks in and inflation remains below the 2% target, they are that much more likely to implement their proposed average inflation targeting policy. This allows the Fed to accept inflation above 2% without needing to increase rates.

Such a policy shift will not have much credibility with the current 2.5% Fed funds rate. The market will figure this out before the Fed does, and this will force the Fed to cut.

Are these expectations for lower economic growth and the Fed being forced by the market to cut rates bad for risk assets? Not necessarily. 2% growth is not great, but it's no recession. The Fed cutting rates creates better alignment between longer term bond yields and shorter term interest rates and therefore, keeps yields across all maturities relatively low.

Corporate earnings growth also remains low but positive. This provides a valuation floor for risk assets, such as US equities, global REITs, and US high yield bonds, And allows for continued modest gains from here.