Markets have a way of wearing people down. By moving in one direction or staying within a range over an extended period, markets convince people that the present trend is the only plausible one. This scenario describes the current low interest rate environment.

When the Federal Reserve first cut the federal funds rate to zero in 2008, most investors viewed the move as temporary and planned for higher rates in the near future. Now that rates have remained low for over seven years, many forecasters have begun to rationalize why rates must stay low, or move even lower. Yet history shows that markets move in cycles which, by definition, require periodic changes in direction. What could cause interest rates to move higher? We see catalysts in both inflation and changing demographics.

**Inflation**

As we discussed last quarter in our report, “Too Much, Too Many,” a glut of supply throughout much of the world has pushed down prices of many goods. This has been particularly true for commodities such as oil. As shown in Figure 1, the U.S. Consumer Price Index (CPI) fell in late 2014 due to a sharp decline in commodity prices. However, the CPI Core, a measure that excludes food and energy, was relatively steady.

More recently both the CPI and the CPI Core have risen as we have lapped, on a year-over-year basis, 2014’s sharp drop in commodity prices. The rise—driven by higher prices for housing, rents, health care, and education—could be signaling higher inflation to come. By our analysis, if in 2016 the rate of inflation for all non-commodity items remains at 2015 levels and the inflation rate for commodities is zero, the CPI will increase by a rate of 1.6% versus 2015’s rate of just 0.7%. If in that same scenario commodity prices rise just 2% in 2016, the overall CPI inflation rate jumps to 2.3%.

**FIGURE 1**

US Consumer Price Index

Source: FactSet

Higher Interest Rates May Be Coming

“*What could cause interest rates to move higher? We see catalysts in both inflation and changing demographics.*”

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Though a 2.3% inflation rate may not sound like much, it is both above the Federal Reserve’s 2.0% target and the U.S. 10-Year Treasury bond's current yield of 1.8%. Therefore, we believe that a rise in inflation to that level would cause both short-term and long-term interest rates to move higher.

**Demographics**

A shift in demographics may be the primary catalyst that drives a new secular trend of higher interest rates. Throughout people's adult lifetimes, the need to borrow (demand) and the ability to save (supply) change. When a population shift changes the mix of borrowers versus savers, it affects interest rates, just as demand and supply affect the prices of goods and services.

We focus on two age groups when forecasting the impact of demographics on long-term changes in interest rates. The first, ages 25 to 34, makes up the peak new-household-formation group. People in this group are in the money borrowing phase of life as they take out mortgages and lines of credit to buy houses and all the things that go with setting up a new household. As shown in Figure 2, the size of the U.S. population in this age group is projected to grow over the next ten years. Along with that growth, demand for borrowing should also grow thereby putting upward pressure on interest rates.

The second group, those aged 50 to 64, includes the peak savers. People in this age group are typically earning the highest wages of their lives and, to prepare for retirement, saving a much higher portion of those earnings than the general population. This age group, which currently includes members of the “baby boom” generation, is projected to shrink during the next ten years. As it does, the corresponding reduction in the supply of dollars being saved will also pressure interest rates to rise.

Predicting the timing of interest-rate turns is complex and not without its risks. However, given the current low level of interest rates, bond investors sacrifice very little by being defensive in their positioning, relative to the significant risk inherent in positioning for further rate declines. What does this mean for you? At Goelzer we are managing bond portfolios in accordance with our forecast that interest rates will rise over the coming years. We are doing this by keeping maturities shorter than our long-term targets, buying bonds with larger interest coupons, and adding credit exposure. More recently, we have begun to add inflation protection by purchasing Treasury Inflation Protected Securities. We believe this defensive positioning will serve you well should our forecast prove to be correct, with limited downside if it does not.

![Projected Changes in Key U.S. Population Age Groups](image)

**FIGURE 2**

<table>
<thead>
<tr>
<th>Age Group</th>
<th>2015</th>
<th>2025</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age 25 to 34</td>
<td>+3.5 mil</td>
<td></td>
</tr>
<tr>
<td>Age 50 to 64</td>
<td>-1.6 mil</td>
<td></td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau

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