ANALYTICS INVESTMENT ADVISORS, LLC

**WHEN WILL INTEREST RATES RISE?**

Presented by

Richard C. Hoyt
August 11, 2012

The last time the Federal Reserve raised the benchmark U.S. interest rate was June 29, 2006 when federal funds rate hit 5.25%. It has declined ever since, and has stayed at 0%-0.25% since December 16, 2008. The question is not if interest rates will rise, but when and by how much?

At the present time the Fed has little incentive to raise rates. The United States economy generated only 75,000 new jobs per month in the second quarter of 2012, unemployment is currently at 8.3%, and the housing and business sectors are far from robust. Hiking the federal funds rate in such an environment would be counterproductive. In fact, the Fed's rationale for its current policy is that interest rates need to stay at or near these levels until we reach full employment (5-6%) to encourage business investment and big-ticket purchases by consumers.

Moreover, the US economy is experiencing very mild inflation (1.7% during the past 12 months), the demand for capital isn't what it was before the recession, capacity/utilization ratios are less than historical norms, the Federal Reserve, the Bank of Japan and the European Central Bank are all printing more money to encouraging low interest rates. So instead of hyperinflation, many economists see tame consumer prices for several years.

When interest rates rise, however, investors will not want to be stuck with a 1-2% TIPS return. For example, a federal funds rate increase of 3% could cause a longer-term Treasury to lose as much as a third of its market value. As we have seen recently in Greece, Italy, Spain, France and Portugal, easy credit and poor lending practices initially lead to excessive debt, asset bubbles, sustained economic decline, and minimal yields on long-term bonds; followed by higher interest rates as credit ratings decline and risk of repayment increases. This scenario is also possible for the United States economy given that the total US debt now is greater than GDP, yearly expenditures have exceeded tax revenues by over 1 trillion dollars per year for three years, and the national political debate does not appear able to fashion an efficacious solution.

Because of the uncertainty with the timing and magnitude of an inevitable increase in interest rates, investors looking for income options may wish to consider the Vanguard Total Bond Market ETF (BND), which tracks the Barclays Capital Aggregate Float Adjusted Bond Index and/or an ETF with an attractive yield, good diversification and elevated concentration, such as First Trust Morningstar Dividend Leaders Index (FDL).

This commentary was derived from materials prepared by MarketingLibrary.Net Inc., but modified to reflect the views held by Analytics Investment Advisors, LLC.