FIRST QUARTER 2017 – FIXED INCOME

More Fed Rate Hikes, Fiscal Stimulus, and Higher Inflation Expectations

As our Global Macro Strategy Team looks ahead to 2017, we believe the election of Donald Trump unleashed forces that are likely to push interest rates and inflation expectations higher in the U.S. The global picture is more mixed, though we generally believe that global growth and inflation are likely to remain relatively low in the near term, which could help constrain U.S. rates.

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Co-Chief Investment Officer

The world has changed since last quarter. Trump's victory has dramatically altered the political and economic landscape in ways that are still being determined, as we outline in our *CIO Insights Introduction* piece this quarter ("2017 Outlook: Preparing for Uncertainty and Volatility in a Post-Election World").

Even prior to Trump's victory, the fixed income market was poised for change. Yields had been so low for so long that a shift to more historically normal levels appeared increasingly likely. This seemed particularly true in the U.S., but U.S. bond yields were constrained by global factors, including slow global economic growth, massive central bank monetary stimulus, and geo-political turmoil. Many of these factors remain in place and could continue to constrain interest rates globally.

But in the U.S., interest rates are under increased upward pressure, driven by the following factors:

- **Interest rate normalization.** The Federal Reserve (the Fed) wants to raise short-term interest rates toward more historically normal levels. "Lower for longer" has ended and is being repriced by the market.
- **Fiscal stimulus.** Trump's proposed tax cuts and increased government spending while central bank policy remains very stimulative.
- **Inflation expectations.** Trump is proposing to inject fiscal stimulus into an economy with relatively low interest rates, low unemployment, and rising wage pressures.

We believe the Fed wants to resume normalizing interest rates—monetary policy has been abnormally accommodative since 2008. This helped stabilize the global economy and capital markets, but historically low interest rates punished savers and rewarded risk-taking behavior. That increased the odds of financial market bubbles and other imbalances, including inflation. We think the Fed believes that by increasing interest rates in small increments at a moderate pace, it can avoid bigger, more concentrated moves later that might be more disruptive, and help keep inflation contained.

At the same time the Fed is moving toward reducing monetary stimulus, which had anchored short-term interest rates, Trump is proposing to significantly increase fiscal stimulus. This fiscal stimulus could boost economic growth expectations, require more government bond issuance, and increase demand for resources, all of which could push inflation expectations and interest rates higher.

But not a lot higher, following the post-election "Trump Treasury Yield Jump" that's already occurred. We're not as bearish as others in our industry. We believe the 10-year Treasury yield will trade in a range of 1.85% to 3.00% in the next 12 months, constrained at the upper end by global factors that we think aren't likely to change dramatically in the near term.

Meanwhile, U.S. inflation expectations are rising. Inflation was already creeping higher before the election because of rising U.S. labor, health care, and housing costs, and expectations have increased even further since the election. For these reasons, we believe investors should consider inflation-protected securities[1] and strategies as part of an overall risk-management strategy for their portfolios. For investors concerned about rising interest rates, we suggest shorter-maturity inflation-protection securities and strategies.

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[1] Debt securities that offer returns adjusted for inflation.

Generally, as interest rates rise, bond values will decline. The opposite is true when interest rates decline.

The opinions expressed are those of G. David MacEwen and are no guarantee of the future performance of any American Century Investments portfolio.

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