U.S. Interest Rate Outlook: 2018 and Beyond

U.S. SHORT RATES ARE QUITE PREDICTABLE THIS YEAR

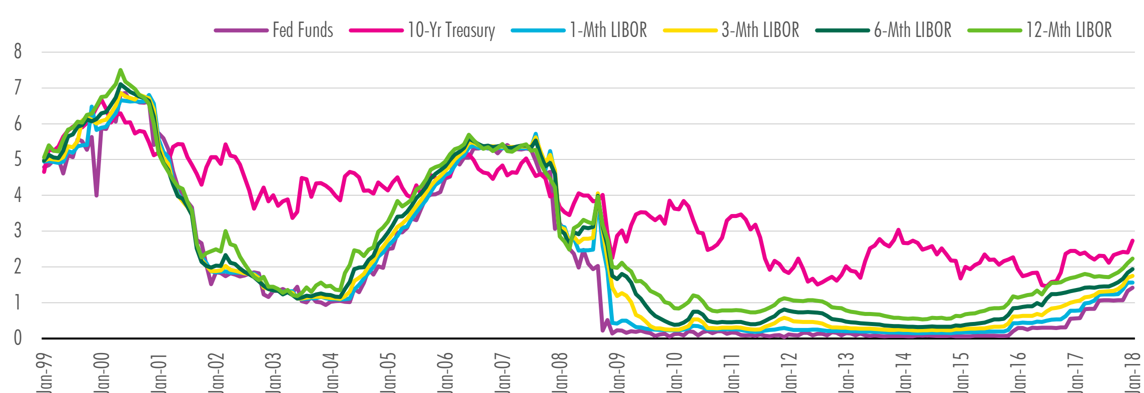
- The FOMC will increase the Fed Funds rate three times this year, with a fourth increase possible.
- The impact of fiscal stimulus, an increasingly tight labor market and, possibly, personnel changes, may make the FOMC more hawkish.
- However, the FOMC will continue to pay close attention to core personal consumption expenditures (PCE). January 2018's 1.5% PCE was below the stated target of 2% inflation.
- The 10-year break-even inflation rate has been slightly above 2% for much of January 2018, indicating that inflation expectations remain low.
- We expect the Fed Funds rate to be at 2.25% by the end of 2018 and at 3% by the end of 2019.

10-YEAR U.S. TREASURY RATES WILL BE SLIGHTLY OVER OR SLIGHTLY UNDER 3% BY YEAR END

- Arguments for rates over 3% include the unwinding of the Fed's considerable balance sheet and unexpectedly high inflation as wage growth picks up. Indeed, the current sell-off may overshoot.
  - Moreover, central banks outside of the U.S. may unwind their quantitative easing policies more quickly than expected due to the strength of global growth.
- Arguments for rates under 3% involve unexpected shock scenarios—perhaps from geopolitics or a trade war driving an increase in demand for risk-free assets.
  - In this case, central banks outside of the U.S. might choose to unwind QE more slowly.
  - U.S. wage growth continues to be weak.
- We think the 10-year will be just under 3% by the end of 2018, but will likely rise to 3.5% in 2019.

LIBOR

- The London Interbank Offered Rate (LIBOR) remains a benchmark on the pricing of debt globally, even as reforms are being proposed.
- U.S. dollar LIBOR will remain closely correlated with U.S. interest rates. With five rate hikes since December 2015, LIBOR rates across all maturities (1-, 3-, 6- and 12-month) have risen (see chart below). With three rate hikes penciled in for 2018, we expect LIBOR rates to climb higher as well.



- With the 10-year expected to settle at just under 3% and the target Fed Funds rate to rise at least three times in 2018, we expect the 6- and 12-month LIBOR rates to settle closer to the 10-year Treasury. The 12-month LIBOR is currently about 50 bps lower than the 10-year Treasury, which is trading at 2.73%.
- Given that the LIBOR is used as the benchmark to price some $350 trillion of U.S. securities ranging from derivatives, student loans and home mortgages to credit card and other types of unsecured lending, the convergence of short-term LIBOR rates and long-term interest rates could be a source of concern, especially if the latter does not see a commensurate increase from rising short-term rates and the Fed's balance sheet reduction.
- Although LIBOR continues to be used as a benchmark on the pricing of debt, a transition from U.S. Dollar LIBOR to a new benchmark is underway. Tasked with managing the transition, the Alternative Reference Rate Committee (ARRC) proposed a new index—the Broad Treasury Financing Rate (BTFR)—which the Fed plans to begin publishing in the first half of 2018. While LIBOR reflects unsecured money-market-based borrowing between banks, the BTFR measures the cost of overnight repurchase agreements (repo) secured by Treasurys.

U.S. ECONOMIC OUTLOOK

- EA is currently updating its economic outlook for jobs and the economy.
- Components of the recent U.S. tax reform law are likely to boost consumption and investment, though lack of labor may hold the economy back. We have upgraded our GDP forecast for 2018 from 2.3% to 2.6% and the risk is on the upside.
- Certain large U.S. corporations have announced that they intend to repatriate their offshore cash holdings at a one-time preferential rate; this will put upward pressure on the dollar which, perversely, might slow growth in H2.
- The U.S. real estate investment environment remains attractive, with strong demand side fundamentals but a growing supply pipeline.

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