Washington Crossing Advisors

WWW.WASHINGTONCROSSINGADVISORS.COM

Kevin R. Caron
Portfolio Manager
(973) 549-4051
kevin.caron@stifel.com

Chad A. Morganlander
Portfolio Manager
(973) 549-4052
chad.morganlander@stifel.com

Matthew J. Battipaglia
Analyst
(973) 549-4047
matthew.battipaglia@stifel.com

About Washington Crossing Advisors
WCA strategies are offered through the Stifel Score Program (Research-Driven Portfolios). The management team has worked together for the past 20 years as market strategists and portfolio managers.

About Stifel
Founded in 1890, Stifel is one of the leading financial services firms in the U.S., providing full-service brokerage and investment banking services. Stifel is a leading underwriter and advisor for companies and a top provider of trade execution and securities distribution with nationally recognized research and a suite of asset management strategies.

OUR VIEW OF INTEREST RATES POST FED MEETING

A Subtle Tilt in Message by the Fed

Ben Bernanke told markets this week that the Fed intended to "let up on the accelerator" but "not apply the brakes" as the economy appears to be "getting better." Markets took this as a sign the era of ultra-easy monetary policy may be ending and began to price into the bond market a tightening of policy in the road ahead. Market expectations are now for the asset purchase "tapering" beginning as early as September, the end of "quantitative easing" by the middle of 2014, and the beginning of actual interest rate increases by mid 2015.

The positive view of all this relates to the reasons behind the anticipated moves. The Federal Open Market Committee increased both their expectation for growth and lowered their expected unemployment rate. During his press conference following the rate announcement, Fed Chairman Ben Bernanke emphasized that the Fed was prepared to either tighten or ease policy in response to evolving data and highlighted both the improving employment picture, along with improvements in housing, as contributing to the better outlook. As generally positive as this statement seems on the surface, the statement hinted at higher interest rates, and bond prices responded accordingly.

Implications for Investors

We have long held that the economy is involved in a long and slow process of recovery that will eventually lead to a normalization in interest rates. We have advocated a tactical shift to a shorter duration portfolio as one way to reduce risk under a rising interest rate scenario and further emphasize and reiterate this point given this week's policy statement from the Fed. With the Fed's tacit acceptance of higher real rates, we think it is reasonable to assume some additional caution and are further shortening durations in portfolios.

Importantly, ***we wish to emphasize that any process of normalizing rates is likely to be a longer one, but given historically low rates, the risk / reward trade-off still suggests caution from today's levels***. We think a ***process of adjustment could take longer than past cycles given continued weak loan demand and still low levels of resource utilization in the economy***. Nonetheless, a process of normalizing rates implies that interest rates and economic growth should eventually become re-connected should the economy improve along the lines envisioned by the Federal Reserve.

STIFEL

Where Could Rates be Headed?

Plotting the future path of interest rates is a fool's errand, but recognizing the current disconnect between forecast growth and today's level of rates is rather straightforward.

The **Fed's long-run expected growth rate for the economy is 4.3-4.5%** (2.3-2.5% real growth plus 2% core inflation). Over the past 30 years, the average 10-year Treasury bond yield was about 0.6% above the growth in the economy. Therefore, if the Fed is right about a long-run growth path (4.3-4.5%) and the historic growth / yield relationship eventually reasserts itself, then we might expect that a long-run target for the 10-year U.S. Treasury yield would be somewhere between 4.9-5.1%.

A Long Road to Go

We believe that this transition to higher rates will take considerable time and will not be in a straight line. A major weakness in the "higher rates now" scenario is the absence of borrowing and credit growth. This lack of growth marks a major difference between what is happening now and past credit cycles. Today, despite the Fed's best efforts, the overall growth in credit was just 3.4% in 2012 compared to average historic growth near 9%. As you can see from the following table, a strong relationship exists between credit growth, economic growth, and interest rates. Given the still tentative recovery in credit growth, we are anticipating that higher rates may come but likely will come gradually and assuming the Fed's growth scenario comes to pass.

Tactical Implications

Recognizing that interest rates remain still at very low levels relative to underlying growth, ***continued special attention to portfolio duration is still warranted, in our view***. Accordingly, we have taken actions to shorten duration further in model portfolios by ***reducing holdings of longer-term bonds*** and ***reallocating a portion of those assets to shorter-duration floating-rate securities***.

Credit Growth, GDP Growth, and Interest Rates (1960s-2000s)

	Growth in Borrowing (Credit)	GDP Growth	Interest Rates (10-Year U.S. Treasury)
1960s	7.4%	7.2%	5.0%
1970s	11.4%	10.4%	7.5%
1980s	11.3%	7.6%	10.2%
1990s	7.1%	5.5%	6.5%
2000s	7.0%	3.8%	4.4%
Average:	8.8%	6.9%	6.7%
Since 2007	2.1%	2.2%	2.6%
2012	3.4%	3.5%	1.8%
Correlation With Interest Rates	91%	53%	

Source: Bureau of Economic Analysis, Federal Reserve

DISCLOSURES

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, and you cannot invest directly in an index.

As interest rates rise, prices on bond and other interest rate-sensitive investments will fall.