First Trust
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"Low" Foreign Rates Won't Keep US Rates From Rising

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Let's imagine a college basketball team had a 13-1 record in conference play and was 26-4, overall, going into the NCAA tournament. You might assume it gets a top seed in the tourney and is favored to go deep, maybe even reach the Final Four. But what if we told you the team was Harvard?

They got a 12th seed in the tourney. No one is, or was, knocking Harvard. The Crimson had an awesome team last year, bumping off Cincinnati (a 5th seed) and then holding their own, until finally succumbing, to Michigan State. Everyone knows the12th seed Harvard was given made sense…it's never just about the win-loss record.

Why bring this up? Because we keep hearing comparisons about US interest rates versus foreign interest rates. Some investors think long-term US rates can't possibly go up, and might even fall, because many foreign interest rates are lower than US rates. The 10-year US Treasury yield is 2.6%, Japan is at 0.6%, Germany is 1.1%, and France is 1.4%. Italy is at 2.5% and even Spain has just a 2.3% yield. All these countries have much higher default risk than the US.

Ask an academic economist how this can happen and he'd probably say something about "interest-rate parity" and "forward currency markets." This theory says that if we adjust interest rates by expected changes in the value of a currency, then, in fact, interest rates are equal around the world. So, if you can earn a higher rate, you will pay for it with a falling currency. Do the math, and rates are always at "parity."

But this "blackboard economics" doesn't work. The Euro and yen have been declining versus the dollar and should stay on that course as the Europeans and Japanese loosen up monetary policy at the same time the Federal Reserve moves gradually towards tightening and higher short-term rates.

Instead, we think economic fundamentals can explain the current foreign interest rate conundrum, while also pointing to rising US rates. Nominal GDP growth in the Eurozone – real GDP growth plus inflation – is 1.2% annualized in the past two years. In this context, it makes sense that German and French long-term rates are 1.1% and 1.4% respectively, very close to where the fundamentals say they should be.

Interest rates in Italy (2.5%) and Spain (2.3%) are about 100 basis points higher than in Germany and France. Why? These countries have even slower nominal GDP growth than Europe as a whole. The answer is "default risk."

In other words, once adjusted for the fundamentals, European interest rates aren't really "low," just like a 12th seed in the NCAA tourney for Harvard wasn't a slap in the face.

It also makes sense for Japan. Although nominal GDP is up at a 1.3% annual rate in the past two years, Japan has actually experienced a contraction in total nominal output over the past 20 years. Investors are still waiting to see whether "Abe-nomics" can permanently break this long term decline. You may think Japan should have a higher bond yield, but its longer-term growth data say a 0.6% yield is reasonable.

By contrast, US nominal GDP is up at a 3.7% annual rate in the past two years (and 4.4% annually over the past 20 years). But long-term rates are only 2.6%. In other words, on a relative basis, adjusted for the fundamentals, US rates look really, really low and should move higher in the next few years.

The bottom line is that comparing the level of interest rates across countries with no reference to other economic data risks coming to a very wrong conclusion. You can't just look at a won-loss record, you can't just look at yield. Once we adjust for fundamentals, we think rates are headed higher.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-15 / 7:30 am	Empire State Mfg Survey – Sep	16.0	**13.2**	27.5	14.7
8:15 am	Industrial Production – Aug	+0.3%	**+0.2%**	-0.1%	+0.4%
8:15 am	Capacity Utilization – Aug	79.3%	**79.3%**	78.8%	79.2%
9-16 / 7:30 am	PPI – Aug	+0.0%	**0.0%**		+0.1%
7:30 am	"Core" PPI – Aug	+0.1%	**+0.1%**		+0.2%
9-17 / 7:30 am	CPI – Aug	0.0%	**0.0%**		+0.1%
7:30 am	"Core" CPI – Aug	+0.2%	**+0.2%**		+0.1%
9-18 / 7:30 am	Initial Claims – Sep 14	305K	**303K**		315K
7:30 am	Housing Starts – Aug	1.040 Mil	**1.020 Mil**		1.093 Mil
9:00 am	Philly Fed Survey – Sep	23.0	**25.7**		28.0
9-19 / 9:00 am	Leading Indicators – Aug	+0.4%	**+0.5%**		+0.9%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.