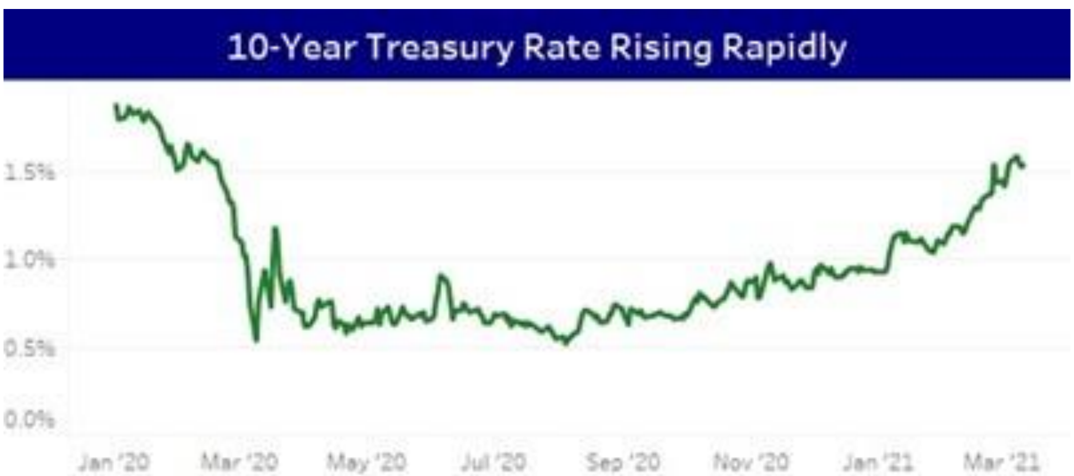
What's Happening with Interest Rates?

Interest rates and inflation expectations have been in the news lately because both are rising. The increases are linked. The underlying causes are the improving economy and the extraordinary fiscal and monetary actions taken over the last year.

What's happening? Interest rates are rising because the economy is improving fast as the virus recedes in the U.S. Many anticipate growth accelerating in the middle of the year as case levels fall further, service industries open back up in earnest, and consumers spend their recent relief payments and the savings they have compiled over the last year (about $2 trillion in aggregate).

An improving real economy causes interest rates to rise because investors seek less safety in low-risk investments like U.S. Treasury bonds, instead searching for better yields in riskier investments. At the same time, businesses are looking to invest more to capitalize on the improving economy. The competition for the investment funds drives rates up.

Since January 1, the ten-year Treasury rate has increased 61 basis points, from 0.93% to 1.54%. That is still a historically low rate (the 10-year was 2.71% in January of 2019, for instance, and that was relatively low), but a 61% increase in just over two months is a sharp uptick.



Why it matters: Higher interest rates on Treasuries will translate into higher mortgage rates, higher rates for business borrowers, and others taking on debt. The flip side is that it will mean higher rates for savers, who have seen almost 0% rates on their savings for over a year now.

The other factor driving up interest rates is the rising expectation of inflation. During the pandemic, Congress has injected trillions of dollars into the economy through stimulus payments and other spending. The Federal Reserve has also put trillions into the financial system. These actions have caused consumers, investors, and businesses to expect higher inflation soon. When they expect inflation, lenders require higher interest rates to account for their money losing value over time.

The difference between regular Treasury rate and inflation protected rates (TIPS) shows inflation expectations. At the beginning of the year, those differences showed investors expected 2% inflation. They now expect inflation closer to 2.4% – a more than 16% increase in a short period of time.

Bottom line: Look for interest rates continue to rise because of the improving economy. Inflation expectations are probably built-in for now. But if inflation rises more, those expectations will rise too and drive rates up further.

—Curtis Dubay, Senior Economist, U.S. Chamber of Commerce