Invesco Strategist Sees Continued Slow Growth, Low Rates in the U.S.

By Randy Myers

The Federal Reserve may have just ended its massive quantitative easing program aimed at keeping interest rates low, but don't expect rates to spike significantly higher as a result, says Rob Waldner, chief strategist and head of multi-sector for Invesco Fixed Income.

Opening the second day of the 2014 SVIA Fall Forum on October 14, Waldner noted that while the U.S. economy is on solid footing it isn't likely to grow rapidly anytime soon, especially with a variety of structural factors, including demographic headwinds, limiting the potential for economic growth globally. Slow growth usually translates into modest interest rates.

Laying out his case for slow growth, Waldner explained that economic potential can be expressed as the product of available labor, labor utilization and productivity—or, in layman's terms, the number of people available to work, the number that actually participate in the workforce, and how productive they are.

From 1982 to 1990, Waldner said, GDP growth in the U.S. exceeded 4 percent annually. It's been trending lower ever since, and the outlook now is for growth to continue at about a 2 percent annual rate. Why? The labor force participation rate—the percentage of working-age Americans participating in the workforce—has been declining since 2000, and productivity has largely been flat. Meanwhile, with baby boomers edging into retirement, the number of available workers is expected to grow only modestly, too, over the next decade and a half. Finally, neither the government nor the private sector seems inclined to invest in capital projects right now, further constraining growth.

Some analysts have bemoaned the declining labor force participation rate, arguing that the economy is so bad that many Americans have simply given up looking for work—and that the unemployment rate is therefore even worse than the official number would suggest. Waldner said his firm's analysis suggests that the declining participation rate is primarily due to permanent factors, such as people choosing to retire early because they can or because of disabilities, rather than secular or cyclical reasons, such as the slow-growing economy. If so, the unemployment rate, which had fallen to 5.9 percent by September from its post-recession high of 10 percent in October 2009, is the best indicator of how tight the labor market is. And that performance suggests the labor market is tightening. While the general consensus—and the view of the Fed—has been that the U.S. will not reach "full employment" until 2015, Waldner said Invesco Fixed Income believes that could happen as early as the fourth quarter of 2014. Normally that would suggest interest rates should go higher, but the slow-growing economy, and a stretched-out economic cycle, are working to mitigate that.

Waldner said the U.S. economy appears to be just about midway through a normal cyclical pattern that will soon see wages improving, but that the cycle is likely to be longer than the normal 6.4 years—perhaps as long as 9 or 10 years—due to the depth of the financial crisis that preceded it. He observed that Europe is early in its economic cycle, Japan is just behind the U.S. and China is late in its cycle. These differences are prompting different policies from central bankers around the globe. While the Fed has been winding down its stimulative quantitative easing program, he said, bankers in Europe and China are starting to ease while the Bank of Japan continues to try to stimulate inflation.

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Waldner said that as the U.S. yield curve continues to flatten, long-term interest rates in the U.S. should be "relatively well-behaved." He characterized the 10-year Treasury note as "slightly overvalued" at its recent yield of about 2 percent. If the economy continues to grow at about a 2 percent rate and inflation remains at 2 percent or below, he said, the 10-year note would be fairly valued at a yield somewhere in the 2.5 percent to 3 percent range. He put the chance of yields rising much above that—to 4 percent or 5 percent—as unlikely. "The message is there won't be a big increase in long-term rates," he said.

What does all this mean for fixed-income investors? Economic growth will continue to be slower than it had been prior to the Great Recession, Waldner concluded. Credit market fundamentals in the U.S. are good but mid- to late-cycle, so valuations are not compelling and volatility is increasing. With Europe earlier in its economic cycle, credit could perform a little better there over the next few years, with peripheral European bonds likely to tighten relative to core securities as fundamentals improve.

The trend toward a stronger dollar is likely to continue, which could be tough on emerging markets whose own currencies will struggle. Fixed-income investors should consider underweighting the short end of the Treasury yield curve, Waldner said. They also should favor the dollar over the euro, the yen and many emerging market currencies; position their portfolios tactically within market sectors; and seek alpha from security selection. SVIA