Market *Alert* **Feb 2010**

STANDARD & POOR'S

Bracing for Higher Rates

With current short-term rates still hovering near historical lows, most agree that rates have nowhere to go but up, especially given mounting budget deficits and an improving economy.

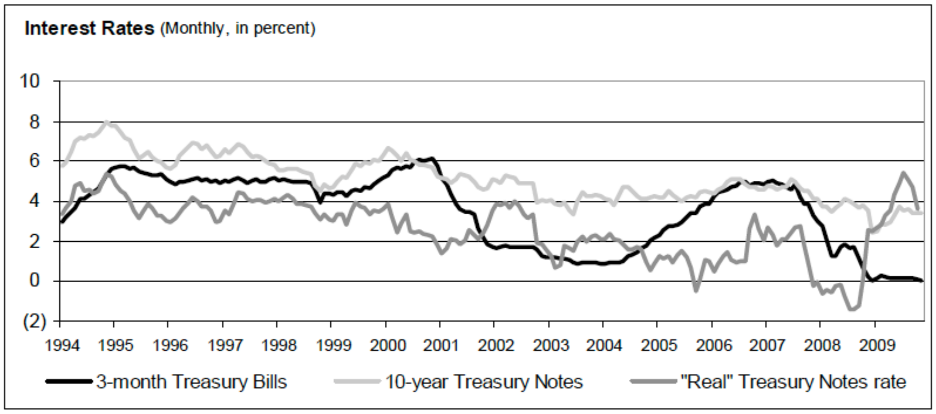
There has been much buzz lately about the prospect of rising interest rates in the not-too-distant future. With current short-term rates still hovering near historical lows, most agree that rates have nowhere to go but up, especially given mounting budget deficits and an improving economy. Some long-term rates have already crept up, and many feel that the Fed will soon begin hiking its key short-term federal funds rate. The question is when.

At its most recent Open Market Committee meeting, the Federal Reserve maintained a 0.0%-0.25% target range and reiterated that economic conditions are likely to warrant "exceptionally low" rates for an "extended period." At the same time, it signaled growing optimism about the economy, stating that "economic activity has continued to pick up" and "financial market conditions have become more supportive of economic growth." Participants agreed that underlying inflation "is likely to be subdued for some time."

The Fed has also announced its exit from the various support programs, ending purchases of long-term Treasuries in October and purchases of other debt as of February 1, 2010. Banks have either paid back or committed to pay back almost all of the TARP funds.

Still, it seems unlikely that the Fed will raise the federal funds rate until there is clear evidence that the unemployment rate has peaked: Raising rates before then is economically dangerous and politically suicidal. S&P currently believes that continued financial nervousness and rising unemployment likely will keep the Fed on hold through mid-2010.

Nowhere to Go But Up?



Sources: Standard & Poor's; the Federal Reserve. Real Treasury Notes Rate adjusted for inflation (CPI).

Strategies in a Rising-Rate Environment

If - or when - interest rates do start to rise, there are several points investors should keep in mind:

- Bond prices will decline if rates tick up, because of the inverse relation between interest rates and bond prices. Historically, rising interest rates have caused the prices of existing bonds to decline because newly issued bonds carry higher rates, which pushes down the value of previously issued securities. Bonds with longer-term maturities are most sensitive to rate changes.
- Stock markets tend to react negatively to rising interest rates, which increase the cost of borrowing and impact corporate bottom lines. Financial stocks are especially sensitive to rising rates, since their funding base is tied to current market rates, although past performance is no indication of future results.
- Fixed-income investors may want to consider dividend-paying stocks, which offer current income as well as the potential for longer-term price appreciation.
- As short-term rates rise, rates on savings accounts and CDs will also rise, making them more attractive to investors. Rates on floating rate debt are also tied to short-term rates. The higher rates rise, the more sense it makes to pay down such debt whenever possible, especially higher-rate debt such as credit cards.
- Long-term rates do not necessarily follow the lead of short-term rates and are, in fact, driven by a host of other factors. As of January 28, the rate on 30-year U.S. Treasury bonds stood at 4.57%, up 188 basis points from December 31, 2008, while the average 30-year mortgage rate stood at 4.98%, down 40 basis points over the same period.[1]

[1]*Source: The Federal Reserve.*