4 Things That Will Happen When the Fed Raises Interest Rates

By **David Harris** | 02/03/15 - 08:12 AM EST

NEW YORK (TheStreet) -- Over the last several years, investors in developed markets have come to know the number zero intimately.

Cash yields have been at zero across North America and Europe for most of the last five years, and in Japan since the 1990s. The search for an alternative with a more rewarding yield drove most high quality bonds down toward zero and eventually, carried over to higher yield debt, emerging market debt and even drove down equity yields.

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This is changing now, but in ways unimaginable before zero became so familiar.

The Federal Reserve is finally getting close to moving rates higher later this year. Yes, disinflation has temporarily intensified with the collapse in energy prices and slow global growth has removed the urgency. But recent weakness in capital expenditures in the U.S. oil extraction industry masks a tremendous boost to real consumer purchasing power that should lead to higher discretionary spending and a virtuous effect on job growth and wages. The recent decline in long term interest rates - a "reverse taper tantrum" - has lowered borrowing costs and is stimulative to the economy overall. As a result, confidence is soaring and borrowing is picking up. With this backdrop, the Fed has every reason to finally move rates upward from zero and may even do so in the first half of 2015.

In other developed markets the opposite is happening. The European Central Bank recently cut official rates to negative 0.25%, and its quantitative easing program announced last week has driven some government bonds yields below zero.

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Indeed, negative yields are rampant: German government yields have broken below zero all the way out past five years to maturity and negative yields exist in France, Netherlands and Austria to list a few. Other European bonds yields have collapsed. Italian 10-year yields, which were above 7% during the 2011 European financial crisis are now just 1.4%. And the Swiss National Bank cut its official rate to negative 0.75% on January 11 to dissuade capital flows into its market. As a result, some short term Swiss Franc yields are now below negative 1% and even 10-year government bonds yields are slightly negative. The entire Japanese government bond curve hovers in a netherworld around zero, with negative yields out to two years.

Zero is no longer the norm in developed markets. But while the causes of the move up away from zero in the U.S. and the move through the zero floor in Europe and Japan are clear - that is, divergent economic conditions leading to divergent monetary policy - we are more interested in the implications of this divergence; for both markets and investors:

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1. The U.S. dollar should continue to rise. The end of U.S. quantitative easing coupled with the expected beginning of European QE (and accelerating QE in Japan) were the engine for the dollar's increase versus the euro and the yen in 2014; interest rate differential will be the driving force in 2015.

2. Volatility will be high and rising. The persistence of zero rates has led to complacency in many parts of the bond market as people take higher risks to generate return. The move away from zero rates in the U.S. will leave some people exposed to losses and disrupt markets in general.

3. Bond yields will remain low everywhere. Investors who can buy bonds outside of their home market are moving to the U.S. for the dual benefits of a stronger dollar and a higher running yield. To some investors, even a small negative return incurred from rising rates is not enough to deter investors from the compelling positive dollar story.

4. The traditional relationships between economic fundamentals and market yields will remain broken for a long time. The cumulative central bank interventions in markets is unprecedented and deeply distorts supply. For example, the Federal Reserve now owns more than 45% of all Treasuries greater than 10 years to maturity. Those looking for long term yields to normalize will need to contend with this dearth of supply, in addition to the unusual demand coming from overseas.

While this should be the year that savers will welcome having U.S. short term rates finally move away from zero, it's doubtful we should expect to move too far away in 2015.

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This article is commentary by an independent contributor. At the time of publication, the author held no positions in the stocks mentioned.