Rising Rates: What History Has to Say

To keep inflation at bay, the Federal Reserve has announced its intention to raise interest rates, spooking both stock and bond markets. But rising rates need not spell bad news for investors.

The Fed currently forecasts three 0.25% increases in the federal funds rate in 2022.

Higher interest rates are headed your way. As inflation has ticked up, so too has the Federal Reserve's stance on interest rates. The question now is not *if* the Fed will raise rates this year, but how many times. Fed Chair Jerome Powell currently forecasts three 0.25% rate increases in 2022, but some Fed watchers predict that rates will go up by 100 basis points or more by year-end.[1]

For investors, rising rates are often considered the harbinger of volatility, as businesses and consumers scale back in the face of tighter credit. But history paints a different, more nuanced picture. In fact, higher rates impact different investments differently.

Stocks

Historically, stock prices have swooned in the face of rising rates. Yet the swoons have generally been minor and short lived. A recent study of the effect of rising rate cycles on stocks found that in the four rate-hiking cycles of the past 30 years, the S&P 500 dropped an average of 1.8% in the three months after the first hike. But it then went on to erase the loss and stood an average of 4.6% higher after six months, and 7.7% higher after 12 months.[2] Another study looked at rate increases between 1980 and 2015 and found that stocks don't follow a straight path up or down in reaction to a rate hike. Instead, they present a mixed bag of performance.[3] A key factor affecting the movement of stocks in relation to interest rate hikes is where in the business cycle the economy might be when rate increases commence. In earlier stages, investments have tended to produce positive returns, but as the cycle matures, returns begin to diminish.[4]

Keep in mind that some sectors fare better than others in a rising rate environment. Banks, for instance, may be able to capitalize on rising rates. And defensive sectors, such as utilities, energy, consumer staples, and health care, have tended to perform better, as these sectors produce necessary goods and services that have less reliance on consumer discretionary spending.

Bonds

There is an inverse relationship between bond prices and interest rates: As rates rise, bond prices fall (and vice versa). In general, the longer the maturity of the bond, the more it fluctuates in response to changes in interest rates.

Bond investors may gain some protection from rising interest rates by selling bonds in their portfolios that won't mature for many years and replacing them with bonds that have shorter maturities. The trade-off is that short-term bonds generally pay interest at lower rates than long-term bonds.

Cash

Cash and short-term money market instruments are perhaps the biggest winners in a rising-rate environment. Since their yields are pegged to the Fed funds rate and other short-term rates, they become more attractive investments as rates rise. That said, unless interest rates rise very significantly, cash still offers a much lower return than stocks or bonds over time, although past performance is no guarantee of future results.

Beyond Interest Rates

Of course, factors other than interest rates can play an equal or greater role in driving asset prices. The economy, political developments, technology, and many other factors impact valuations and returns. And then, of course, there's COVID. So, as you try to assess the impact of rising rates on your portfolio, keep in mind that it is only one factor. Also consider that interest rates rise and fall over time. For long-term investors, it's best to focus on your goals and not get too caught up in short-term volatility. A financial professional can offer valuable insights on how best to manage your portfolio in a rising-rate environment.

[1]Source: Yahoo News, Markets brace for the possibility of four Fed interest rate hikes this year, January 10, 2022.

[2]Source: Businessinsider.com, The Fed is set to hike interest rates in 2022. Here's what that means for US stocks., December 21, 2021. A cycle is defined as a series of four rate increases, made at no more than six-month intervals.

[3]CNBC.com and Nuveen Asset Management, "When the Fed raises rates, here's what happens," September 17, 2015.

[4]Fidelity, "First rate hike; what you need to know," September 9, 2015.

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