Rising Rates: What It Will Mean for Stocks and Bonds

By Matthew Jarrell | December 07, 2015
http://www.investopedia.com/articles/financial-advisors/120715/rising-rates-what-itll-mean-stocks-and-bonds.asp?utm_source=investing-basics&utm_medium=email&utm_campaign=Basics%20-%2012/16/15&utm_term=investing-basics&header_alt=f

Many would argue that The Fed missed it when there was an opportunity raise rates in September 2015. Citing concerns for global economic slowdown, Fed Chairperson, Janet Yellen, announced that rates would not move but were expected to move at some point before the end of the year. Whether good or bad, rates didn't move as volatility picked up in late August and continued through September and into October. Specifically, the Federal Funds Rate, or the rate at which banks can charge one another for overnight loans, is the focus of this article. We'll be looking at its effects on different asset classes within the investment world.

In the U.S. we have what's known as a central banking system. Our central bank is the Federal Reserve, a both private and public company that's been in existence since 1913. It was created by the Federal Reserve Act. The Fed, as it's commonly referred to, is responsible for setting monetary policy within our economy. After the financial crisis in '08 and '09, the Fed eased rates to free up money within our system. This means that borrowing money, theoretically, became easier and very inexpensive. The Fed Funds Rate has been at 0% for several years while the economy has been in the recovery stage. This "easy" policy was coupled with bond buying which capitalizes the banks and floods the economic system with currency, theoretically. "Easy" money policy is designed to get the economy moving again and prop up a system that needs stimulus. What comes next with that influx of new currency into the system is the possibility of deflation. Deflation could mean economic disaster if not controlled with a rising interest rate or inflating the currency. That's why we move interest rates within our system. (For more, see: *Did the Fed Miss its Window to Raise Rates?*)

As mentioned earlier, the global economic system has been in a state of flux over the last few years with different parts of the world experiencing the effects of the financial crisis and the varying regional recovery cycles. This is worth mentioning as our rate hike will, undoubtedly, impact the rest of the globe because of the size and scope of our economy.

How Do Equities Respond?

When you consider the most recent historical rate hikes, global equities have generally pulled ahead prior to and following a rate hike.

"In the last 32 policy-rate hike cycles globally, local equity markets gained a median 12% in the 12 months leading up to the start of the new rate cycle. A similar pattern emerges from the same sample of global cycles after the onset of a new rate regime, with the median equity market rising 10% in

"In the last 32 policy-rate hike cycles globally, local equity markets gained a median 12% in the 12 months leading up to the start of the new rate cycle. A similar pattern emerges from the same sample of global cycles after the onset of a new rate regime, with the median equity market rising 10% in the year following the initial hike." - Goldman; Barron's, How Do Stocks Act When Rates Rise?

U.S. domestic equities have also shown gains over the long term after a rate hike. One might contend that rising rates are favorable for equities. That being said, moving rates too quickly could have an adverse effect on global equities so the Fed is safeguarding against such sharp increases. (For more, see: see *How Interest Rates Affect the Stock Market.)*

How Do Bonds Respond?

Bonds have an inverse relationship to interest rates. Bonds have risk that is very different than that of equities. For the purpose of this article we'll be focused mostly on interest rate risk. Interest rate risk loosely means that as interest rates increase, bond prices can fall. Duration is the measure of how sensitive a bond is to interest rate movements. Maturity is the expected life of the bond. The shorter the maturity the less sensitive to interest rate movements. Maturity is used to determine duration. Bonds should be broken into segments as each has a varying degree of sensitivity to interest rate movements. Let's keep it simple with these five categories: high-yield, municipal, short, intermediate and long term. Let's start with the least sensitive and move toward the most sensitive. (For more, see: *High Yield Corporate Bonds: Different Structures and Types*.)

High Yield - High yield corporate bonds are issued by corporations seeking to generate capital. These bonds are backed by the credit worthiness of the private and public companies. Corporate bonds have call risk as well. Because they have shorter maturities and increased credit risk, most corporate bonds are less sensitive to interest rate risk.

Municipals - Munis, depending on the issuer, have been fairly resistant to interest rate movements for some of the same reasons high yield bonds are. Municipalities issue debt in the form of a general obligation bond or revenue bond. These bonds are backed by the credit worthiness of the issuing municipality. Use caution when selecting an individual municipal bond. (For more, see: *How Stable Are Municipal Bonds?*)

Short Term - Repayment of principal expected in 6 months to 3 years. Pretty simple here, the shorter the term of the bond or bond's portfolio, the less sensitive it is to interest rate movement. A portfolio of short-term bonds could have a duration of 3-4 years depending on the desired yield by the investor. (For more, see: *The Time for Short Duration Bonds is Now*.)

Catholic Foundation
1988 - 2016

Intermediate Term - Repayment of principal expected in 3-10 years. Begin using caution when putting intermediates in your portfolio.

Long Term - Repayment of principal expected in more than 10 years. Long-term bonds are very sensitive to interest rate movements when compared to short and intermediate-term bonds.

Bonds issuers understand reinvestment risk and offer caveats such as floating rates within the issue. Floating-rate bonds offer a certain protection as interest rates move upward when compared to fixed-rate bonds. Floating rates move with the interest rate up or down, therefore the principal of the underlying bond is protected against loss when interest rates move unless sold prior to maturity. However, a floating rate bond has interest income that is unpredictable within a rising or falling rate environment. There is also the risk of default when carried by a corporation. They are generally tied to a benchmark of the Federal Funds Rate or LIBOR, which is the rate at which international banks charge each other for overnight loans. (For more, see: *An Introduction to LIBOR*.)

The Bottom Line

Each asset class has a unique relationship to interest rate movements. The long and short of it is this: know your time horizon. When do you plan on using the money? How will interest rate movements impact your current income needs? You should seek help with this one if you don't understand how to calculate this. Overall, rate movements could be interpreted as a good thing for the global economy. Easy money policy seems to have come to a turning point. Maybe we'll get a 0.25 of a point just in time for Christmas. (For more, see: *Interest Rate Risk.*)

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful. Past performance is no guarantee of future results. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield. High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Catholic Foundation
1988 - 2016

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

Read more: Rising Rates: What It'll Mean for Stocks and Bonds | Investopedia
http://www.investopedia.com/articles/financial-advisors/120715/rising-rates-what-itll-mean-stocks-and-bonds.asp#ixzz3v9Zfi6eb
Follow us: Investopedia on Facebook