

# Eye on the Fed -- and Interest Rates

With the yield on the 10-year U.S. Treasury note and rates on 30-year fixed-rate mortgages on the ascent, investors are left to wonder whether interest rates are poised to follow suit.

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## A Rapid Rise

As of May 30, yields on the benchmark 10-year Treasury note stood at 2.1% -- still low by historic standards, but nearly half a percentage point higher than at the start of May.<sup>1</sup> Further, the average 30-year fixed-rate mortgage had risen to 3.81%, up from 3.51% just weeks earlier.<sup>2</sup>

Testimony before Congress last week by Federal Reserve Chairman Ben Bernanke, as well as the release of minutes from the Federal Open Market Committee's (FOMC) latest meeting, sent rumblings through the market as investors strained for any indication that the Federal Reserve might slow its massive \$85 billion monthly program of "quantitative easing," which could signal the beginning of a period of higher short-term interest rates.

## Economic Growth and Monetary Policy

Indeed, signs of an improving economy have been accelerating lately, with initial jobless claims falling in the week ended May 18 and new home construction recording gains 35% above their prior-year level in April.<sup>3,4</sup> Addressing the question of whether the Fed was considering a shift in its current monetary policy, Bernanke said only that "the Committee will continue to assess the degree of progress made toward its objectives in light of incoming information."<sup>5</sup>

Most notably, those "objectives" include an unemployment rate of 6.5% (the current rate stands at 7.5%, well above the Fed's target) and an inflation rate no more than half a percentage point above the Fed's long-range goal of 2% (consumer price inflation rose only about 1% over the past 12 months ending in March 2013), down from about 2.25% for the previous 12 months. Chairman Bernanke also reiterated that he expects "a highly accommodative stance of monetary policy to remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens."<sup>5</sup>

## Guidance for Investors

While at present there is no indication that the Federal Reserve intends to begin raising interest rates any time soon, when the inevitable does occur, it is important to be prepared by considering how such a move might affect your investment portfolio.

**Stocks:** Historically, stock prices have fallen when interest rates rise. It should be

noted however that the negative effect of rate hikes on the stock market has tended to be short-lived. For example, since 1975, the Federal Reserve has raised rates five times. During these periods, stocks -- as measured by the S&P 500 -- lost, on average, 0.9% during the first three months after the initial rate hike, but they gained, on average, 0.5% after six months, 4.7% after 12 months, and 3.3% after 18 months. Of course, past performance cannot guarantee future results.<sup>6</sup>

Moreover, different companies' stocks react to rising rates in different ways, with some sectors and industries being more sensitive to interest rate moves than others. That is why the best, most balanced approach to dealing with interest rate uncertainty is to hold a well-diversified mix of stock investments including those of different sectors, market caps, and investing styles (e.g., growth vs. value). While diversification does not guarantee against a loss, it can create the potential for some securities in your portfolio to perform well when rates rise, even if others do not.

**Bonds:** Rising interest rates usually cause bond prices to fall. As investors flock to new bonds because of their higher yields, owners of existing bonds reduce prices in an attempt to attract buyers. Investors can help mitigate the potential risk rising rates present to a bond portfolio by exercising some of the following strategies:

- **Duration management:** Duration is a term used by fixed-income investors to determine how a bond's price may react to changes in interest rates. Reducing the duration of a bond portfolio can help to lessen its sensitivity to interest rate changes. While you cannot change the actual duration of a bond or bond portfolio, you can switch bond "maturities" from long-term to short-term. Since interest rate risk increases over longer periods, bonds with shorter maturities cause duration to decrease.
- **Diversify:**
  - **By maturity:** Since interest rates may not increase in tandem along the maturity spectrum, holding a mix of short-, intermediate-, and longer-term bonds (sometimes referred to as bond laddering) may help to minimize interest rate volatility while still maintaining some potential for higher income.
  - **Globally:** Not all countries will experience interest rate increases at the same time as the United States.
  - **By sector:** Some sectors of the bond market may have less of a price impact from rising rates than others (e.g., some non-government or corporate bonds).

If you are trying to gauge the impact of rising interest rates on your stock or bond portfolios, remember that rates tend to move in cycles, as does the overall economy. Rather than let today's headlines drive your investment strategy, your best move may be to maintain a long-term perspective and talk to your financial advisor about your needs.

<sup>1</sup>Source: *The Wall Street Journal*, "Swoon in Bonds Puts Eye on Fed," May 30, 2013.

<sup>2</sup>Source: Freddie Mac, weekly mortgage rates (for periods indicated).

<sup>3</sup>Source: S&P Capital IQ, *The Outlook*, "Don't Fight the Fed," May 27, 2013.

<sup>4</sup>Source: U.S. Census Bureau and U.S. Department of Housing and Urban Development, news release, May 16, 2013.

<sup>5</sup>Source: Board of Governors of the Federal Reserve System, Chairman Ben S. Bernanke, testimony before the Joint Economic Committee, U.S. Congress, Washington, D.C., May 22, 2013.

<sup>6</sup>Sources: S&P Capital IQ Financial Communications; the Federal Reserve. Stock returns represent price changes only and do not include the effects of reinvested dividends. Gains are not annualized.