Three things to know when interest rates rise

As you know, unless you’ve been living under a rock, interest rates have been low for a historically long time. The forecast by many financial experts is that as the economy continues to improve the Fed will start the process of raising rates, potentially this September. This upcoming action by the Fed can be both good and bad thing.

As investors it’s important that you understand what that impact may be, either good or bad ***so that you can look at your portfolio carefully for any risks that you may not be aware of.***

Here are three things that you must keep in mind as the Fed starts the process.

1. There will likely be some short term volatility. As the Fed meeting(s) take place and the rate decision comes out, you will most likely see some short term volatility in the market. No one knows whether that volatility is bullish, bearish or potentially both leading too little or no change in the market.

The important part is to understand that this volatility can be very dangerous. Investors tend to overreact to these short term knee jerk reactions which can lead to trouble. Certainly you can take advantage of the volatility by selling some options or some other strategy, but that’s for the savviest of traders. I’ve witnessed these types of volatile event based moves before and the result for most investors/traders is usually not a good one. Trade the volatility only if you understand the risk you are taking and are confident in your trading ability.

2. Rising interest rates are not bad for stocks. After the decision is made and the short term volatility takes place, you will hear from some folks argue that the bull market is over. They may say something like “*the landscape that caused this bull market is now over . . . look out!*” That however, couldn’t be farther from the truth. Let’s take a look at the numbers.

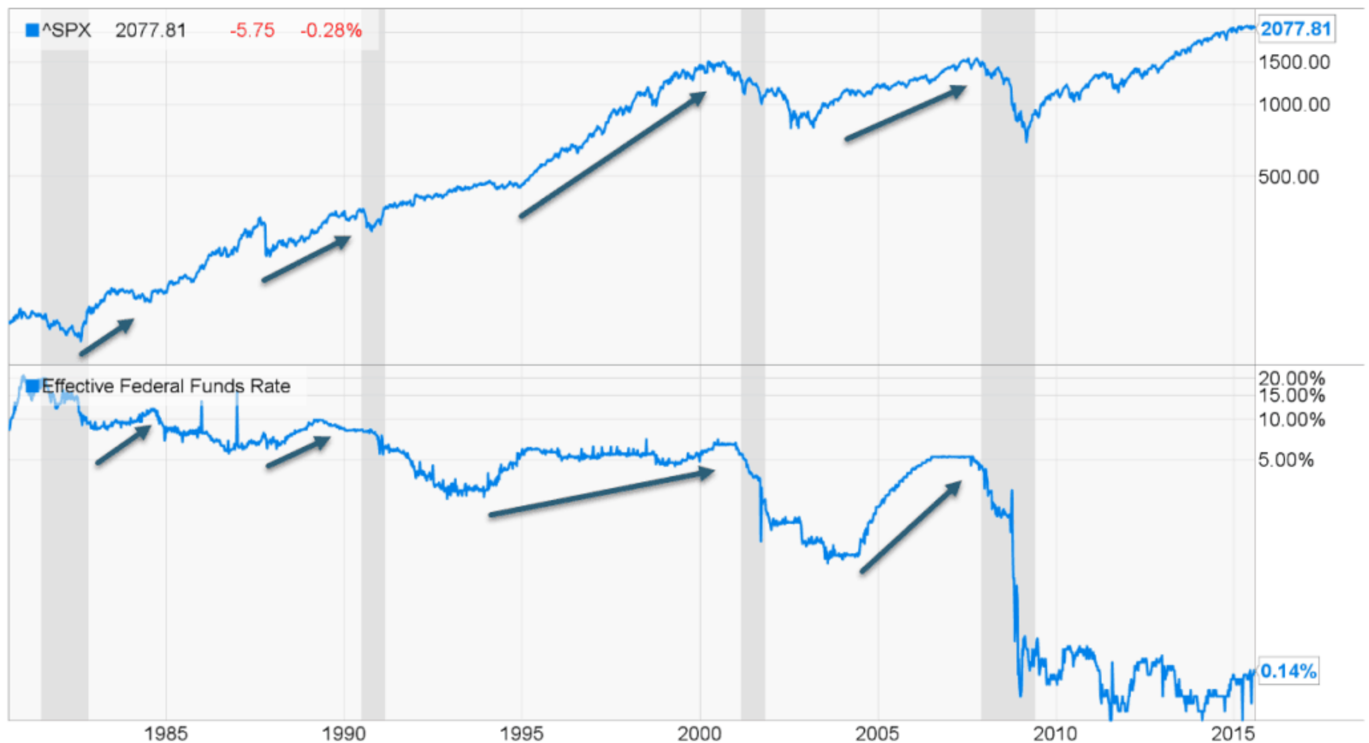
Below is a table that shows what the MSCI All World Country Index (a common benchmark) did before the initial interest rate hike and what it did after. You can see that the average return in the 12 months following a rate hike is 7%. For the 24 months following the hike it is 19%. While that is no guarantee that anyone will make money, history shows that there is a high probability that the bull market will continue.

DATE OF FIRST RATE HIKE	PRIOR 12 MONTH % RETURN	NEXT 12 MONTH % RETURN	NEXT 24 MONTH % RETURN
JULY 16, 1971	31.2	13.5	19
AUGUST 16, 1977	-1.5	15	19.8
OCTOBER 21, 1980	18.9	-13.6	-8
MARCH 27, 1984	11.8	8	62.6
DECEMBER 16, 1986	40.8	14.1	37.6
MARCH 29, 1988	.9	11.7	9.8
FEBRUARY 4, 1994	27.2	-3.9	17.4
JUNE 30, 1999	14	10.7	-12.1
JUNE 30, 2004	21.4	8.7	22.4
AVERAGE RETURNS	18	7	19

Source: Bloomberg

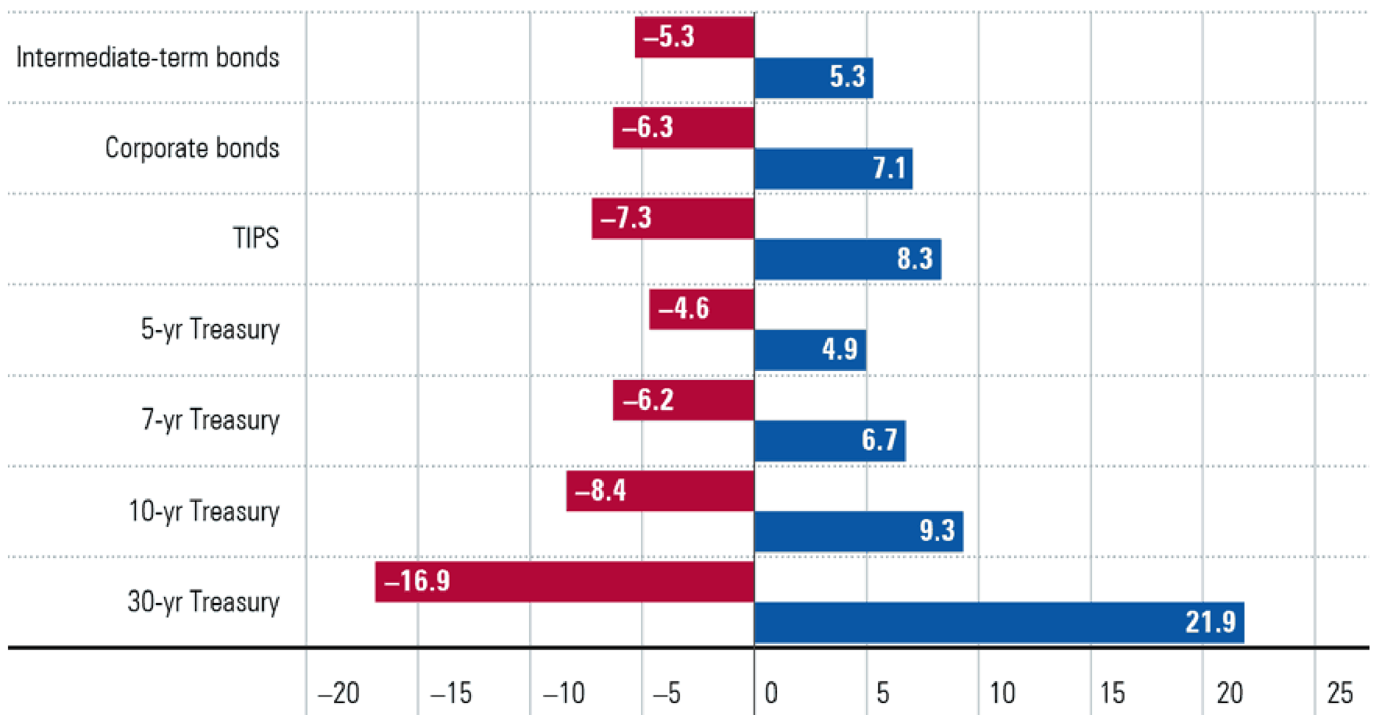
Below is another visual example of the correlation of interest rates to stocks. You will see the S&P 500 index on the top half of the chart and the Fed Funds Rate on the bottom. As interest rates rise, stocks typically move higher. You can see that there are very few times in the last 35 years when

rates went higher that the market didn't as well. (The shaded areas are recessions which is typically when you will see interest rates lowered.)



3. Rising interest rates are not good for the bond market. The notion that you use bonds to help reduce portfolio volatility and to create stability may be rocked as interest rates move higher. There is a negative correlation with interest rates and bonds. Typically when interest rates move higher bond prices move lower.

You can see the impact of interest rates on bond prices below in the table. The red indicates a 1% increase in interest rates. The different types of bonds, some of the supposed safest investments you can buy, are all negative. While the Fed won't move interest rates 1% in one, two or maybe even five meetings, they will eventually get to that point.



Depending on how savvy an investor or their advisor is, there are two ways that someone can take advantage of a bearish move in bonds. 1) They can either reduce the amount of exposure they have to bonds, (especially bond ETFs which don't hold to maturity), or 2) they can look for opportunities to short the bond market. The latter is not a recommendation and should only be done if someone is confident in their ability to sell short.

Finally, I would like to end with one piece of advice. Don't let a rise in interest rates catch you off guard, please review or have your advisor review how your portfolio is currently constructed. Recognize any risks that may exist that you may not currently understand or recognize and take the necessary action to your portfolio that is aligned with your goals.

Contact us with any questions and successful investing! brett@igga.dev