The Buzz on Interest Rates

The Impact of Rising Interest Rates on Investors

Interest rates have been at historic lows for nearly seven years. Economic forecasters are buzzing with their predictions on when the Federal Reserve, "the Fed", will begin gradually raising interest rates. September seems to be the popular guess with most pundits predicting the Fed will begin raising interest rates before the year's end, but only time will tell.

Why would the Fed raise rates?

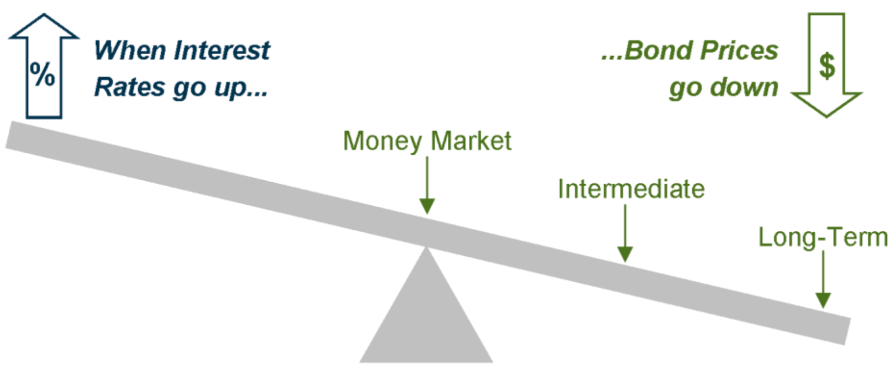
The Fed lowered interest rates to near zero lows beginning in December 2008 in order to boost the economy out of the Great Recession. Now, the U.S. unemployment rate is declining and consumers have more money to spend. Rising interest rates are a sign that the Fed believes the U.S. economy will continue to thrive without stimulus.

What does this mean for investors?

Generally, rising interest rates are good for savers and not so good for borrowers.

For bond investors, rising interest rates equate to a decrease in bond value.[1] However, the severity of the impact varies by the duration of the bond, as shown in Figure 1 below.

Figure 1: The Impact of Interest Rates on Bond Prices



Long term bonds prices are impacted the most when interest rates are on the rise. Adding short-term and intermediate-term bonds, as well as other asset classes, into a portfolio will help hedge against sharp decreases in value. Intermediate-term bonds will be impacted as well, but price decreases will be less than that of long-term bonds. This alludes to how important diversification truly is.

For stock investors, rising interest rates generally depress stock prices. This causes volatility in the market as investors react to the rising rates and falling prices. However,

[1] Schwab-Pomerantz, Carrie. Should You Care About Rising Interest Rates?. Huffington Post Business. http://www.huffingtonpost.com/carrie-schwabpomerantz-cfp/should-you-care-about-ris_b_7926920.html

talk of rising rates before the rates are actually increased can have the same effect. For example, since steady job growth and declining unemployment can indicate an impending rise in interest rates, the release of a fairly positive July 2015 jobs report led to a midday stock downfall on August 7th.[2]

The Bottom Line for Investors

Economic forecasters are predicting a gradual rise in interest rates before 2016. When this will actually happen is up to the Federal Reserve, however, a more normal interest rate environment is on the horizon.

While it is important to understand how interest rates can affect retirement savings, it is crucial to stick to a long-term strategy and not react to every shift in the market. Diversification is essential to mitigate the risk of market volatility associated with rising interest rates.

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[2] The Associated Press. US Stocks Drop After Solid Jobs Report Suggest Higher Rates. The New York Times. 7 August 2015. http://www.nytimes.com/aponline/2015/08/07/world/asia/ap-financial-markets.html?_r=1