Interest Rates on the Move

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Following yesterday's equity market update, we will now take a dive into the current dynamics in the world of interest rates. Interest rates are a hot topic in today's economic and market landscape, and we'll examine the reasons why. In reaction to the COVID-19 induced economic shutdown, the Federal Reserve slashed their key Federal Funds Rate to 0%, effectively. As the economy recovers and inflation on the rise, the Fed is widely expected to raise interest rates 3-4 times (0.25% per occurrence) in 2022, with some on Wall Street seeing the potential for even more than that. In this blog, we'll explore how rising interest rates impact investors, both in their bond portfolios and how stocks react. We will also touch upon the impact to consumers as interest rate increase on consumer loans.

Market Interest Rates

Market interest rates have already started climbing without the Fed having taken any action yet. Before we dive in, let's take a look at some of the increases we've seen in various treasury bond interest rates over the past year (February 26, 2021 vs February 25, 2022):

Treasury Yields[1]:

- 2 Year Treasury: 0.14% > 1.55%
- 10 Year Treasury: 1.44% > 1.97%
- 30 Year Treasury: 2.17% > 2.29%

Impact of Rising Rates for Bond Investors

When it comes to an investor's bond portfolio, it is important to understand the dynamic between interest rates and bond prices. Interest rates and bond prices have an inverse relationship - as interest rates increase, bond prices decrease (think of a teeter totter). Intuitively, this makes sense. If you have a bond that pays 2% interest, and now that same bond is paying 2.5% interest on the market, you would have to sell your bond for less than it's par value to compensate for your bond's lower interest. As such, we have seen negative performance from bonds in 2022 as interest rates have increased and prices have decreased.

What can investors do to limit interest rate risk? For one, lowering duration. Duration is the measurement that tells us how much a bond's price might change if interest rates fluctuate. Often times, duration is expressed in a number of years. For example, a duration of 1 means a 1% movement in the bond's price if interest rates change 1%, a duration of 2 corresponds with a 2% movement in the bond's price if interest rates change 2%, and so on. When duration is lower, so too is a bond's interest rate risk.Therefore, gravitating to bonds with a lower duration should lower a bond portfolio's price loss if interest rates move higher. The same is true in the opposite scenario. A higher duration bond would perform better if interest rates declined.To minimize interest rate risk, Traction Financial Partners has focused on allocating to lower duration bonds in our client portfolios. Also, Traction's use of structured notes (as a bond proxy) effectively eliminates interest rate risk for those holdings as their price is not tied to the interest they pay. Feel free to contact us for more information on structured notes.

Impact of Rising Rates for Equity Investors

Next, let's investigate how equity markets have historically fared once the Fed starts hiking rates.For this, we'll lean on LPL Research's recent piece, Don't Expect The Fed To End This Bull Anytime Soon[2].Starting with the Fed's aggressive rate hiking cycle of the early 1980s, stocks have been positive one year after the initial rate hike in all of eight instances since then. On average, the S&P 500 was up 7.5% six months after the initial hike and 10.8% after 12 months. Stocks not only tend to do well in the immediate aftermath of a tightening cycle from the Fed. Looking back even further to the cycle that started in the Fall of 1958, after the first rate hike, the S&P 500 has gone on to average a 67% gain during bull markets, and they have lasted 3.4 years on average. If history is to rhyme again this time, the start of a rate hiking campaign shouldn't be a major cause for concern for equity investors, in isolation. This LPL Research piece also highlights the market's rotation from growth stocks to value stocks. Higher rates tend to more negatively impact growth stocks relative to value stocks.As of February 25th, value stocks have outperformed growth stocks by over 9.69% (as measured by the Russell 1000 Value index vs the Russell 1000 Growth Index). In anticipation of this, Traction made minor allocation shifts from growth stocks into value-oriented stocks in late 2021/early 2022.

Consumer Loan Interest Rates

As interest rates rise, that means we will all be paying more on our debt in the future. First, let's take a look at how interest rates on the 30 and 15-year fixed mortgages have move over the last year (February 25th, 2021 – February 24th, 2022):

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Average Fixed Mortgage Rates[3]:

- 30 Year Fixed:2.97% > 3.89%
- 15 Year Fixed:2.34% >3.14%

As you can see, before the Federal Reserve has made a single move, the market rates for mortgages have jumped. Therefore, if you are in the market for a new loan or haven't refinanced high-rate loans, now is the time to act. In fact, as of this writing on March 1st, we've seen rates experience a meaningful drop the past two days of the week as investors flocked to the "safer" bond market due to Ukraine-Russia concerns. Bond rates, specifically the 10-year Treasury Bond (now under 1.75%), have a direct impact on consumer debt. This provides a likely brief window of lower rates to potentially take advantage of.

This also means that home equity loans/lines of credit, auto loans, student loan and credit cards will see jumps in rates as well. Consequently, it is even more important to not run balances on your credit cards and to try and secure cheap financing for auto loans while you can.

Final Thoughts

While there is no guarantee that interest rates continue to climb higher into the future, it appears to be the most likely scenario. The Fed is already behind the inflation curve and barring any major economic turbulence in the near future, they will need to raise rates in an attempt to curb inflation. Again, we encourage our clients to act quickly in regard to obtaining consumer loans while interest rates are still historically low – they won't be for long. If you would like to learn more, or if you are not a client and feel you could benefit from Traction's approach to managing risk in your portfolio, we welcome you to reach out to our office.

References

[1] https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2021
[2] LPL's Don't Expect The Fed To End This Bull Anytime Soon .pdf
[3] https://fred.stlouisfed.org/series/MORTGAGE30US