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Rising Rates 101: What You Need to Know

Rate hikes are meant to curb inflation, but could also impact your portfolio.

In a situation that would have Sir Isaac Newton rolling in his grave, we're disproving gravity: what went down (interest rates) must come back up.

Low rates can help spur economic growth by making it cheaper for consumers and businesses to borrow money; conversely, higher rates can be used to cool off an economy that's too hot. Rates were near zero to support the economy during the COVID-19 pandemic, but with today's high inflation, the US Federal Reserve (Fed) is increasing rates in an attempt to stabilize prices.

What Do Rates Have to Do With Inflation?

The Fed sets monetary policy to try to keep the economy humming along with full employment and stable prices. One item in its toolbox is the ability to adjust the federal funds rate, or the rate that banks borrow money from each other. This baseline rate influences interest rates on everything from mortgages and car loans to the interest earned on savings accounts or certificates of deposit (CDs).

Today, with a growing economy and rapidly rising prices, the Fed can raise the federal funds rate to discourage spending by both consumers and companies, which should reduce demand and help rein in inflation. But raising rates will have some other ripple effects, too.

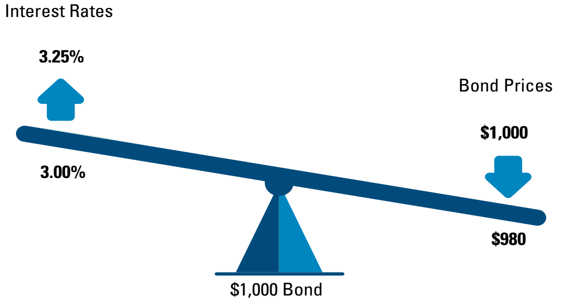
How Might Rising Rates Impact Me?

As with many things, how rising rates might impact you depends on your situation. Higher interest rates hurt borrowers since it makes it more expensive to take out loans, but tend to benefit savers since yields on savings accounts and CDs will eventually improve.

For investors, equities that typically do well in a growing economy could be well positioned to withstand rising rates since the economy is in good shape. But since bonds have an inverse relationship with interest rates—as rates rise, bond prices fall—fixed-income investors are more likely to feel negative effects. Not all types of bonds will react the same way, but fixed-rate bonds with longer maturities are most sensitive to these changes (think US Treasury bonds).

Key Points

- The economy and job market have recovered from the pandemic, and inflation is increasing.
- The US Federal Reserve plans to raise rates multiple times in 2022 and 2023 in an effort to dampen high inflation.
- Higher interest rates can benefit savers and equity investors, but can be more challenging for borrowers and fixed-income investors.



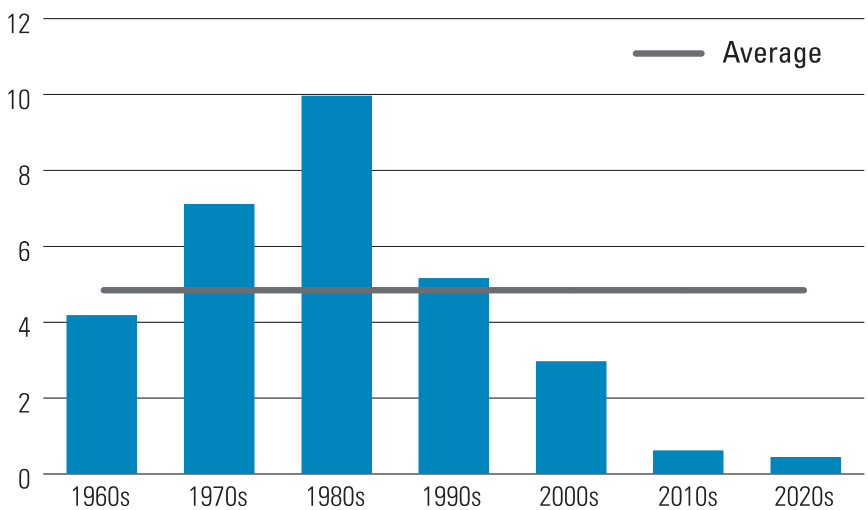
In this example, the price of a $1,000 bond would drop to about $980 if interest rates rose from 3% to 3.25%. The actual amount of price decrease will vary. This chart is for illustrative purposes only.

A Dose of Perspective

For context, the average federal funds rate since 1960 is just under 5%. It's below that today, and the forecasted 4.0-4.5% by the end of 2023 would still be below average. In addition, the Fed has been forthcoming about its intentions, which gives investors time to work with their financial professionals to prepare their portfolios. Finally, bond and equity markets may react in the short term, but higher rates haven't derailed market performance over the long term.

Current Federal Funds Rate Is Well Below the Long-Term Average

Average federal funds rates by decade (1960–Present)



	1960s	1970s	1980s	1990s	2000s	2010s
Average Inflation Rate	2.3	7.1	5.6	3.0	2.6	1.8
Average Bond Returns	1.7	6.2	13.0	8.4	7.7	8.0
Average Stock Returns	7.8	5.9	17.6	18.2	-1.0	13.6

Past performance does not guarantee future results. Average effective federal funds rate, not seasonally adjusted, as of 9/1/22. **Stock returns** are represented by the S&P 500 Index, which is a market capitalization-weighted price index composed of 500 widely held common stocks, using data calculated by Ibbotson Associates. **Bond returns** are represented by the IA SBBI US Long Term Corporate Index which measures the performance of US dollar-denominated bonds issued in the US investment-grade bond market, including US and non-US corporate securities that have at least 10 years to maturity and a credit rating of AAA/AA. Indices are unmanaged and not available for direct investment. Inflation rate, bond returns, and equity returns as of 12/31/21. Sources: St. Louis Fed, US Department of Labor via FactSet, Morningstar, and Hartford Funds.

In many ways, rising rates are a sign the US economy has put the worst of the COVID-19 pandemic behind it. And if the hikes work as intended, the high inflation we've been experiencing could moderate. That would make it far more affordable to buy apples, should you want to channel your inner Newton and re-test gravity.

Talk to your financial professional to help prepare your portfolio for today's rising-rate environment.