Title A: How Will Federal Interest Changes Affect Me?

Subtitle: A non-technical guide to understanding interest rate hike impact.

Title B: Will Fed Interest Rate Changes Hurt My Portfolio?

Subtitle: An overview of how interest rates affect the economy and your investments.

Title C: How Will Federal Interest Changes Impact My Investments?

Subtitle: Truths about federal interest rates every investor needs to know.

Shutterstock

In March of this year, the Fed raised its short-term interest rate to a range of 0.75% to 1%, the highest since 2008. Another rate hike followed in June, taking it up another quarter point. Federal Reserve Chair Janet Yellen alerted Congress that at least one more will occur before the end of 2017. With two rate hikes in the bag and one on “standby,” should you be worried about your investments?

People worry about what a rise in interest rates will do to the value of their bond portfolio. It’s a valid one, too, considering the often costly impact to average consumers and businesses. An interest rate hike impact could be bad news for some and good news for others. Let's look at how you can employ the recent (and future) interest rate changes to your financial advantage:

How Do Interest Rates Affect the Economy?

[Shutterstock]

When fed interest rates rise, there isn't a person who doesn't feel its impact, regardless of what's in your investment portfolio. Average consumers feel the crunch of having to pay more for purchases. Businesses see higher costs with expansion and payroll. These actions create a ripple effect through the credit market, bumping into a myriad of other factors that could impact your investments. If you want to come out ahead, you need to have a view different than the market.

Things That Increase With Rising Interest Rates

The Prime Rate

The prime rate is the credit rate banks offer to their most trusted borrowers, acting as the rate on which other forms of credit are based. A higher prime rate for “good” borrowers also means a higher rate for less credit-worthy individuals.

Credit Card Rates

Banks will be looking more closely at risk profiles, which could affect the ability to borrow funds. Putting credit cards in perspective of the recent quarter-point rate hike, consumers can expect to pay an extra $2.50 per year on a $1,000 balance, says NerdWallet. It doesn’t seem like much per person, but according to WalletHub, that humble figure will be an estimated $1.6 billion in 2017.

Savings Rates (Money Markets, CDs, etc.)

It’s good news to those who aren’t in debt, but those who owe on credit cards or another financial burden may be more likely to pay off their debt than take advantage of higher-earning interest options.

The U.S. National Debt

A boost in borrowing costs typically means a boost in the national debt. A report from the Congressional Budget Office illustrates that the U.S. Government might owe $2.9 trillion more over the next 10 years than if the interest rates stayed closer to zero.

Things That Decrease With Rising Interest Rates

Business Profitability

Unless you’re a bank, you might expect to see your bottom line suffer a blow. Businesses who need capital to expand will be paying more for it.

Consumer Purchases

With higher credit card rates, impulse buys and frivolous spending tend to wane.

Home Sales

With an uptick in the interest rates comes a parallel swing of mortgage rates. Combine that with closer risk profiling and home sales tend to cool.

Actions like a fed interest rate hike can set off a domino train of varied consequences. For example, a company raises its selling price to pay for its increased interest on borrowed capital which forces the consumer to find an alternative product that's more affordable. This loss of business can further impact a company's profitability. The company may further increase its prices to make up for lower profits or cease to exist because they've chased away their customers with unaffordability.

This is one example of infinite possibilities. But, it illustrates the importance of knowing what to expect from a fed interest rate increase from multiple angles, not just how it affects a single investment … which brings us to how you can use these various insights to your investment's advantage.

Stocks to Buy When Interest Rates Rise

Shutterstock

Let’s start with stocks. Given the earlier information, there’s an easily identifiable trend about who benefits well from a fed interest rate hike—the banking industry.

Stocks in the banking industry tend to perform well during rate hikes. They’re lending money for higher rates. And, as Kiplinger notes, “they’re far slower to lift what they pay on deposits, so they earn a wider ‘spread’ between the rates at which they lend and the rates they pay depositors.”

For example, Bank of America calculates that a one-percentage-point increase will result in a net interest income of over $5.3 billion over the next 12 months, giving their net interest income a boost of over 13.5%. Combine that with the potential deregulation and tax cuts from President Trump’s agenda and the bank could see further earnings.

Kiplinger also notes that during these thriving economic times, as the dollar becomes stronger, “so could the demand for loans and credit quality in general.”

Bond Safety During an Interest Rate Hike

Shutterstock

Moving into bond safety brings up a recent conversation with one of our clients who was making a large business purchase and was trying to lock in the rate before the Fed met. Not knowing what interest rates are going to do, I ventured that the market has priced in some sort of hike.

Sure enough, when the Fed acted and raised rates by 25 basis points (BPS), interest rates actually dropped. There was enough speculation that the Fed would raise rates by more than 25 BPS that the bond yield dropped!

People worry about what a rise in interest rates will do to the value of their bond portfolio. Truthfully, it really depends on the duration of the bonds. The longer the duration, the more sensitive the price will be to interest rate changes. This is why, in this interest rate environment, we own bonds that are very high quality and very short duration. Interestingly, in the last 80 years, there have only been 8 years where 5-year treasury returns were negative. Of those 8 years, only one was down more than 3%.

The lesson in this is that the market, whether stocks or bonds, typically prices in all available information. This is one reason why indexing and evidenced-based investing strategies like Dimensional Fund Advisors (DFA) are SO much more effective in this day and age where we have so much information at our fingertips. It's there for the taking, and by all means, you should seize it.

In Closing

Perhaps the best news of the recent Fed rate hikes is that the overall prognosis for the American economy is a healthy one. The Fed wouldn't be raising rates otherwise. Despite the negative consequences of the rate hike, it's still good news in terms of growth and the job market.

If you're concerned about how your investments will fare during the interest rate hike, the biggest planning opportunities in a fixed income portfolio are around understanding:

1. The spread between taxable and non-taxable bonds
2. Where we are in the interest rate cycle
3. Matching credit quality and duration to your cash flow needs
4. Location of the bonds in your portfolio—i.e., taxable or non-taxable (retirement) account

Many factors determine how fed interest rate changes will impact individuals and businesses. Reach out to us today to learn more about how you can prepare your investments to thrive regardless of interest rate activity.