Rising Interest Rates

Their Impact on the Economy and Your Portfolio

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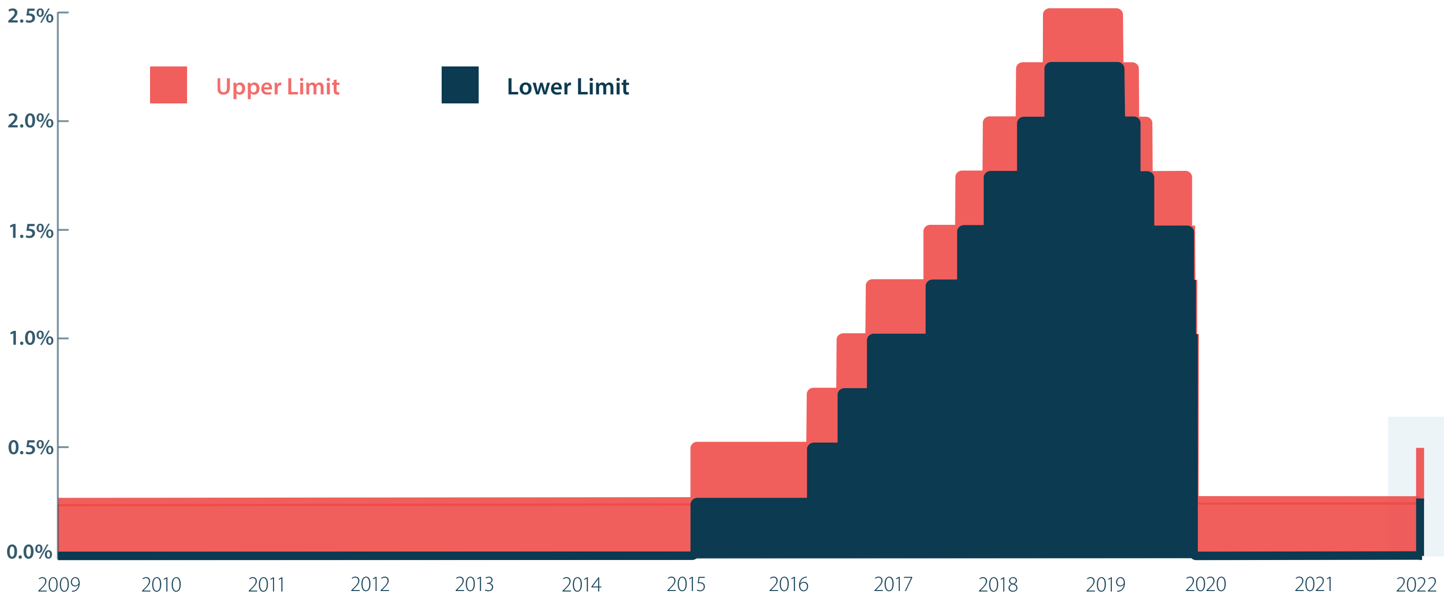
The Federal Reserve has raised rates for the first time in more than **three years.**

U.S. Federal Funds Target Range, 2009-2022

Source: U.S. Federal Reserve Bank of St. Louis (Mar 2022)



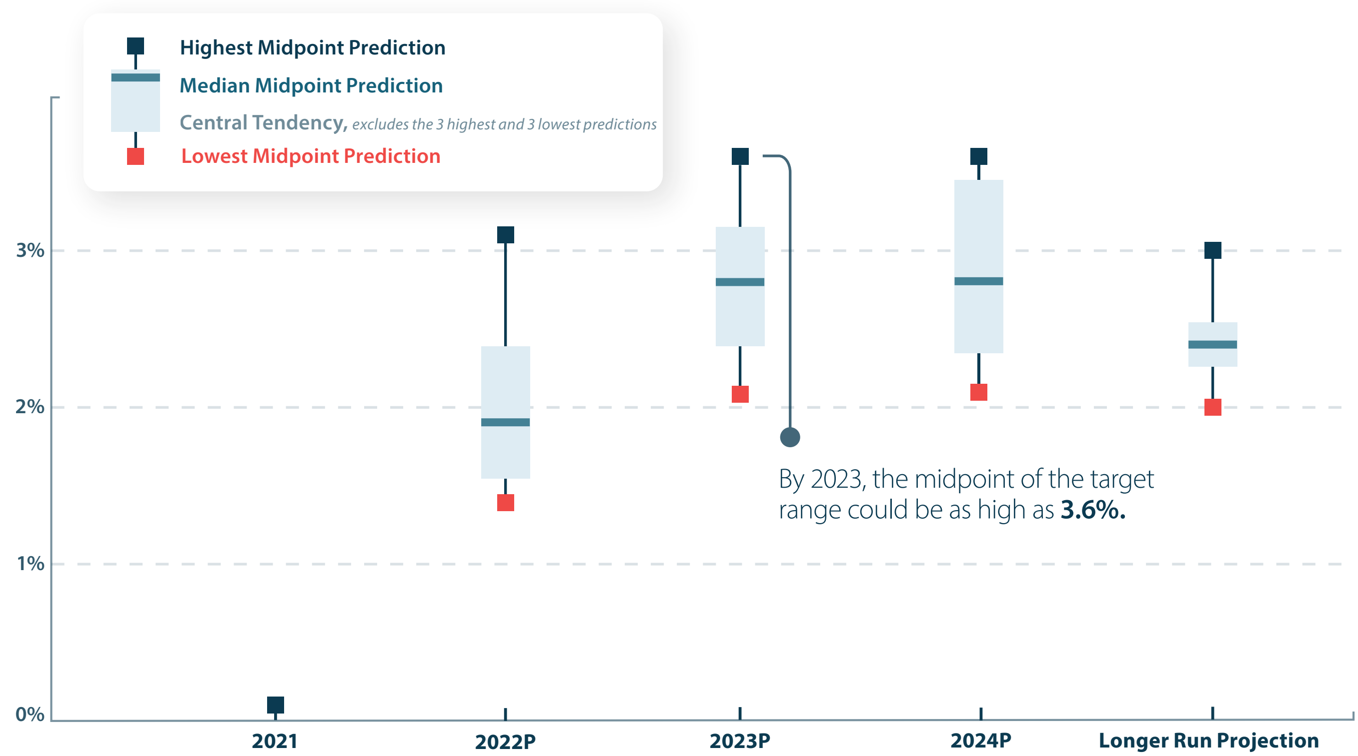
The target range is set by the U.S. Federal Reserve to influence the rate U.S. banks use when lending funds to each other overnight.

On top of the recent increase, the Federal Reserve is predicting that **the rate will rise substantially over the next few years.**

Source: U.S. Federal Reserve (Mar 2022)

Projected Midpoint of the Target Range Over Time

Source: U.S. Federal Reserve (Mar 2022)



Interest Rates and the Economy

Why has the target interest rate risen?

It's all related to the goals of America's central bank. The U.S. Federal Reserve has a twofold mandate:

1 

Maximize employment

2 

Maximize price stability

The inflation rate is key to achieving this mandate.

If inflation is too low, people may put off spending because they expect prices to fall, weakening the economy.

If inflation is too high or volatile, it's hard for people to plan their spending and for businesses to set prices.

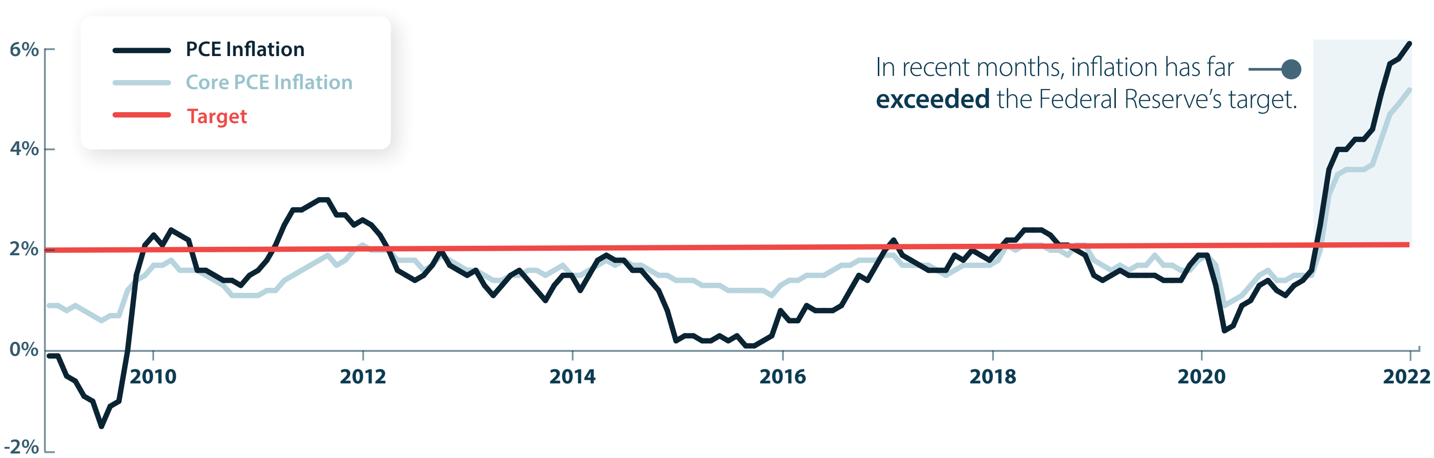
Moderate inflation can help people make informed decisions about saving, borrowing, and investing.

The Federal Reserve targets a **2% inflation rate,** as measured by the Personal Consumption Expenditure (PCE) Index, over the long term.

PCE Inflation Relative to Federal Reserve Target

12 Month Inflation Rate, Seasonally Adjusted

Source: Federal Reserve Bank of St. Louis (Feb 2022). Core PCE Inflation excludes food and energy, which tend to be more volatile categories.



In order to bring inflation closer to the 2% target over the long run, the Federal Reserve has raised interest rates.

This has historically led to **lower inflation.**

Federal funds target rate rises

Banks charge households and businesses higher rates on loans

Households and businesses cut back spending and increase savings

Demand for goods and services falls

Companies raise prices more slowly, or lower prices

Inflation drops

Against this economic backdrop of rising interest rates,
how can investors best position their portfolio?

Choosing Investments for Rising Interest Rates

The potential for losses with a change in interest rates—known as interest rate risk—affects fixed-income investments most directly.

For example, let's pretend you bought a zero-coupon bond with a 1-year maturity.

Purchase Price
$1,000

Interest Rate
10%

Payment at Maturity
$1,100

Bond Value
$1,000

The day after you purchase this bond, the Federal Reserve raises interest rates. Similar bonds in the market now offer **$1,110** in one year, equivalent to an **11%** interest rate.

A typical investor would not purchase your bond for $1,000 yielding 10% when they can purchase a new bond for the same price that yields 11%. **Your bond's value must drop so that it also offers an 11% return.**

$$\frac{\$1{,}100 \text{ payment at maturity}}{1.11} = \$991$$

Purchase Price
$1,000

Interest Rate
11%

Payment at Maturity
$1,100

Bond Value
$991

The bond has decreased in value by **$9 or 0.9%.**

Source: Morningstar (Jan 2022). This example is for illustrative purposes only and not indicative of any investment. It is hypothetical in nature, does not reflect actual investment results, and does not guarantee future results.

Of course, bonds are not the only investments affected by rising interest rates. **The table below highlights how various asset classes have performed when the Federal Reserve was raising interest rates historically.**

Annualized Returns During the Last Two Rate Hike Periods

	Jun 2004-Jul 2006	Dec 2015-Jan 2019	Average
Bank Loans	5.9%	5.2%	5.5%
Short-Term Bonds	2.9%	1.1%	2.0%
Long-Term Bonds	5.6%	2.7%	4.1%
High-Yield Bonds	8.4%	7.5%	7.9%
Municipal Bonds	4.9%	2.7%	3.8%
Large-Cap Stocks	8.1%	10.9%	9.5%
Large-Cap Value Stocks	12.6%	9.1%	10.8%
Large-Cap Growth Stocks	3.8%	12.3%	8.1%
Ex-U.S. Developed Country Stocks	21.5%	5.5%	13.5%
REITs	24.4%	8.4%	16.4%
Gold	24.5%	7.2%	15.9%
Global Commodities	14.3%	0.3%	7.3%

Source: Morningstar (Feb 2022). Time periods measured from the first Federal Reserve rate hike until one month after the last rate hike, which, on average, is when the effective federal funds rate has tended to stabilize. **Bank Loans** are represented by the Credit Suisse Leveraged Loan Index. **Short-Term Bonds** are represented by the Bloomberg U.S. Treasury Short Index. **Long-Term Bonds** are represented by the Bloomberg U.S. Treasury Long Index. **High-Yield Bonds** are represented by the Bloomberg U.S. Corporate High Yield Index. **Municipal Bonds** are represented by the Bloomberg Municipal Bond Index. **Large-Cap Stocks** are represented by the S&P 500 Index. **Large-Cap Value Stocks** are represented by the S&P 500 Value Index. **Large-Cap Growth Stocks** are represented by the S&P 500 Growth Index. **Ex-U.S. Developed Country Stocks** are represented by the S&P Developed Ex-U.S. LargeMidCap Index. **REITs** are represented by the FTSE NAREIT All REITs Index. **Gold** is represented by the LBMA Gold Price. **Global Commodities** are represented by the S&P GSCI Index. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece.

In light of this historical performance, here are a few things investors can consider:

Fixed Income

Long-term bonds outperformed short-term bonds during the last two rate hike periods, but had a higher level of risk.

Source: Morningstar (Feb 2022)

Portfolio implications:
Taking risk into consideration, investors may want to diversify their portfolios with a variety of bond durations and maturity lengths.

Stocks

Growth stocks have outperformed value stocks over the last decade, but this trend doesn't always hold true during periods of rising interest rates.

Source: Morningstar (Feb 2022)

Portfolio implications:
Investing in U.S. large cap equities overall, which includes **both growth and value stocks,** has historically had the least risk.

Source: Morningstar (Feb 2022)

Alternatives

Global commodities had the highest average return, but also had the highest risk.

Source: Morningstar (Feb 2022)

Portfolio implications:
Investors may consider holding **a portion of their portfolio in commodities** if they have a high risk tolerance.

Weathering Rising Rates

Interest rate hikes have occurred throughout history when the Federal Reserve is aiming to combat inflation.

Diversifying across asset classes, styles, and bond term lengths may increase return potential while helping to manage risk.

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Diversification cannot assure a profit or protect against loss in a declining market.

The Personal Consumption Expenditure (PCE) Index is one measure of U.S. inflation, tracking the change in prices of goods and services purchased by consumers throughout the economy. **Core PCE Inflation** is measured using the same index as the PCE index, but excludes food and energy prices in the U.S. **Zero-coupon bonds** are bonds that do not pay interest during the life of the bonds.

The **Credit Suisse Leveraged Loan Index** is a representative index of tradable, senior-secured, U.S. dollar-denominated non-investment-grade loans. The **Bloomberg U.S. Treasury Short Index** is a universe of Treasury bonds, and used as a benchmark against the market for shorter-term maturity fixed-income securities. The **Bloomberg U.S. Treasury Long Index** is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The **Bloomberg U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging markets debt. The **Bloomberg Municipal Bond Index** covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. The **S&P 500 Index** is widely regarded as the standard for measuring large-cap U.S. stock-market performance. The **S&P 500 Value Index** measures value stocks using three factors: the ratios of book value, earnings, and sales to price. The **S&P 500 Growth Index** measures growth stocks using three factors: sales growth, the ratio of earnings change to price, and momentum. The **S&P Developed Ex-U.S. LargeMidCap Index** is designed to measure the top 85% of float-adjusted market cap in each developed country, excluding the U.S. The **FTSE NAREIT All REITs Index** contains all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. A REIT (Real Estate Investment Trust) is a company that owns, and in most cases, operates income-producing real estate, such as apartments, shopping centers, offices, hotels, and warehouses. To qualify as a REIT, a company must distribute at least 90% of its taxable income to its shareholders annually. The **LBMA Gold Price** means that the price for a Pricing Date will be that day's afternoon London Gold price per troy ounce of Gold for delivery in London through a member of the LBMA authorized to effect such delivery, stated in U.S. Dollars, as calculated and administered by an independent service provider. The **S&P GSCI** (formerly the Goldman Sachs Commodity Index) serves as a benchmark for investment in the commodity markets and as a measure of commodity performance over time.

It is not possible to invest directly in an index. Past performance is not indicative of future results. Different time periods may have different results. This material represents an assessment of the market environment as of a specific date; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. The comments and opinions, contained herein are based on and/or derived from publicly available information from sources that we believe to be reliable. We do not guarantee the accuracy of such sources or information. This information should not be relied upon by the reader as research or investment advice regarding the funds or any particular issuer/security.

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