



Economic and Market Insights

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Economic theatrics? Investors look for clarity on when the Fed will hike interest rates

History dictates that interest rates will not stay low forever, but the speed at which rates rise and how far up they climb is difficult to predict. With ongoing discussion in the marketplace about when rather than if the Federal Reserve (Fed) will raise rates, we thought it was an ideal time to talk with Commerce Chief Economist Scott Colbert about the possible timing and effects of an interest rate hike.

Q. As the Fed continues to mull over the interest rate-hiking question, should I move more or less money into bonds?

A. At this time, Commerce Trust has a slight “underweight” to bonds because interest rates are so very low for the typical bond portfolio. What that means is that we have a bit less money than average invested in bonds and are keeping our bond maturities slightly shorter to compensate for what’s likely to be a modest but nevertheless upward interest rate trajectory over the next year. Note that bonds year-to-date have marginally outperformed most stocks as stocks have been essentially flat.

Q. If the Fed raises rates, does it affect certain types of bonds more so than others?

A. It could and it really depends upon the reason that the Fed is raising rates. If the Fed is raising rates simply to fight inflation, it probably affects most bonds fairly equally with the lowest-yielding and longest-maturing bonds getting impacted the worst, i.e., Treasury bonds. But if the economy is improving and the Fed is pushing back just against growth in general and potential inflation, it probably means corporate bonds and high-yield bonds will outperform.



We actually expect the Fed will only raise rates to slow an improving economy and credit-oriented bonds should do well.

Q. How would a Fed rate hike affect the interest rate yield curve?

A. In general, any interest rate hike is likely to move interest rates more in the shorter maturity sector than in the longer end of the interest rate maturities. For example, 30-year Treasuries are already yielding approximately 3%. By the time the Fed is done raising rates, whenever that is, 30-year securities may still be yielding around 3%. Yet the five-year Treasury, yielding about 1.5% today, is likely to yield at least 2% to 2.5% by the time the Fed is done raising rates, and those bonds are likely to decline the most on a relative basis in price. This is a bit counterintuitive.

Q. Would I do something differently based on whether I own individual bonds or bond funds?

A. Not really. But to the extent you own individual bonds, it's easier for most investors to mentally close their eyes and simply remind themselves that each of their bonds will eventually mature at face value, despite the fact that the bond's selling price fluctuates and is likely declining. Bonds in a bond fund also mature, but since the portfolio is marked to trade daily, investors more readily "see" their losses with any rise in interest rates, and we often have a tougher time convincing holders of bond funds to look through a price decline. In the long run an individual "laddering" or layering bonds at different maturities, constantly reinvested, behaves just like a bond fund.

Q. What is the expected impact on equity investments?

A. In general, a rising interest-rate environment is unfavorable for stocks. However, it depends more upon the speed and slope of the rate-hiking process than the actual direction. If the Fed is aggressive and quick with the rate-hiking process, typically stock prices are down one year later, on average, about 2% to 4%. But when the Fed has been slow and gentle with its rate-hiking process -- and in six of the last 14 rate-hiking cycles it's been gentle -- stocks on average in the S&P 500 were actually up close to 10% 12 months later. We expect the Fed will be exceptionally gentle.



Q. Once the Fed starts with the rate hike, doesn't it have to keep going up from zero for a while?

A. The Fed currently believes it will eventually get short-term rates into the 3% to 3½% range. To the extent that inflation remains at about its 2% target, we think it is very unlikely the Fed will push cash yields much past that 2% without dramatically slowing the economy. So I doubt that rates will rise as high as they have historically once the Fed initiates the next rate-hike cycle.

Q. Any final thoughts?

A. Recognize that the Fed is truly data-dependent. Unless the economy can support higher interest rates, we aren't going to have higher interest rates.

Key Takaways:

- The Fed is intensively data-dependent – if the employment or inflation numbers do not support a rate increase, we will not see one.
- If the Fed raises rates because of an improving economy, the likelihood is that corporate bonds will outperform Treasuries and agencies.
- If the Fed moves slowly and gently with its rate-hiking process, there is a strong likelihood that stocks move upwards over the next 12 months.

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