Economic and Market Insights
June 19, 2015

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What will rising interest rates mean for the stock market?

The Federal Reserve Board (Fed) has been telegraphing a rate increase for some time now so it seems like the question is no longer "if", but "when". Nick Fafoglia, CFA®, a senior Investment Portfolio Manager at The Commerce Trust Company, takes a moment to address the impact of the impending Fed action and the potential impact on stocks.

Q. Is this the beginning of an actual "tightening cycle" or a normalization of rates from the low levels that were put in place during the financial crisis?

A. The first thing investors should understand is that the Fed is moving toward raising interest rates because there has been broad-based improvement in the economy. However, labor markets are beginning to tighten and there are indications of some wage pressures, which can be inflationary as consumers begin to spend at a faster pace. Fed Chair Janet Yellen has made it clear that the number and the pace of rate hikes should be gradual and minimal, with perhaps only one or two modest rate increases seen this year. That should be supportive of stocks and the economy. Most past rate tightening cycles have been rather aggressive, e.g., rate hikes following back-to-back Fed meetings.

Q. What has been the performance of equities when interest rates have risen in the past? Do you have a sense for what might happen this time around?

A. Volatility typically increases, but the beginning of a tightening cycle does not necessarily mean the secular bull market for stocks is coming to an end. Historically, stocks perform well in the months leading up to the first hike, then decline slightly for a relatively short time afterwards. Ten percent corrections are not unusual. In most cases, however, stocks perform well for the two years following the initial hike.

Q. Do you think this tightening cycle will impact how investors go about choosing stocks?

A. The energy and material sectors have been strong relative performers in past tightening cycles when the Fed has increased rates due to rising inflation expectations. However, this time may be different as the Fed's motivation is "normalization" of rates rather than any immediate concern about inflation. Accordingly, stocks within the technology and healthcare sectors may continue to lead the market.

Q. Does that argue for more active vs. passive investing?

A. Active management styles should outperform passive in an environment where there is greater performance distribution and solid economic growth.

Q. Any final thoughts?

A. Timing market moves resulting from Fed policy changes can be difficult. Interest rate tightening cycles do not necessarily spell the end of equity bull markets. In some cases they provide investment opportunities. The key, however, is to remain focused on your long-term goals regardless of the market environment.