Commentary

December 2016

Investment Fundamentals: Who Wins and Who Loses When the Fed Raises Rates?

- The Federal Reserve is responsible for ensuring stable, moderate long-term economic growth and controlling inflation.
- In November, the Fed hinted that the U.S. economy may finally be ready for an interest-rate hike.
- Interest-rate hikes are beneficial for some and detrimental to others.

Now that Britain's surprising vote to leave the European Union and the uncertainty of the U.S. presidential election are both behind us and economic data have shown consistent improvement in the U.S. economy, it appears likely that the Federal Reserve (Fed) will raise the Federal funds rate in December. So who wins and who loses if rates go up?

A Balancing Act

The Fed has two mandates: maximize employment and ensure price stability in order to help businesses and consumers plan for the future.

The Fed controls its Federal funds rate (the amount it charges its member banks to borrow money) in an attempt to balance the inflation rate (the rate at which the prices of goods and services rises). When the Fed funds rate falls, borrowing costs for banks also decrease, and the availability of "cheap money" stimulates economic growth. Conversely, when the Fed funds rate rises, borrowing costs for banks also rise, and are passed to customers in the form of higher interest-rate loans.

Historically speaking, here's who generally benefits (and who doesn't) when the Fed raises interest rates.

Winners

- Savers and retirees: People who squirrel away money in savings accounts are rewarded when rates rise, as their savings earn more interest. Senior citizens benefit from a rate hike because the interest income they live on improves.
- The U.S. dollar: When interest rates rise, the dollar's value rises — assuming other foreign currencies don't keep up with its appreciation. This is especially beneficial for Americans traveling abroad, particularly to Europe, whose currency has seen significant depreciation against the dollar.
- Banks: Banks profit from interest payments charged to business and consumer loans. When the Fed raises interest rates, banks pass along the higher cost of borrowing from the Fed to its borrowers.
- U.S. money-market funds: As interest rates rise, so do yields on money-market funds.
- Short-term U.S. Treasury bonds: the yields on short-term government debt securities are more sensitive to Fed rate shifts than longer-term bonds; when rates rise, so do short-term bond yields.
- Global equities: As the dollar's purchase power rises, more American businesses and consumers can afford foreign-made products. Corporate profits overseas benefit from increased demand.

Losers

- Home buyers and spenders: Higher interest rates translate to higher home-loan costs, especially on adjustable-rate mortgages. Many credit cards have interest rates that adjust based on the Fed funds rate; when it goes up, so do credit-card rates.
- U.S. stocks: the U.S. stock market typically pulls back following an interest-rate hike. That's because rising rates makes domestic business expansion more expensive; investors see this lack of corporate growth, become rattled and tend to sell off their stocks.
- Emerging markets: As more money is directed to the U.S. and other developed markets, emerging-market economies suffer.

Don't Fight the Fed

As always, long-term investors should align their portfolios with their individual investment objectives. While the Fed plays an important role in the economy, short-term interest-rate movements should not determine long-term investment decisions.

Important Information
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