A Rising Rate Environment: Five Reasons for Investors to Keep Perspective

As we move forward towards a return to "normal" from the pandemic, the central banks will be raising rates to more "normal" levels. For many months, the media has been hyping concerns over rising interest rates. As investors, should we be concerned?

While the highly accommodative central bank policies have helped to support the financial markets to see us through the past two years, here are five reasons why investors should keep perspective in a rising rate environment:

1. Expectations of interest rate hikes have been built into the markets. Today, we've been given ample warning by the central banks that rates will be rising, so much of this expectation continues to be built into the markets. While we have become accustomed to the forward guidance given by the central banks today, consider that it hasn't always been this way. In the past, decisions made by central bankers were often a surprise that could rattle the markets. In the 1990s, investors used to guess what the Fed would do based on the size of then-Chair Alan Greenspan's briefcase![1] The theory: if the Fed was going to change rates, Greenspan would be carrying a lot of documents so his briefcase would be wider.

2. Even with multiple rate increases, interest rates will still continue to be low. Even before the central banks implemented these highly accommodative policies, interest rates have been kept at low levels for quite some time. As we learn to manage the pandemic and return to normal, a natural unwinding needs to take place, which includes allowing rates to rise. However, let's not forget that even with multiple rate increases, interest rates will still continue to be very low by historical levels.

3. Businesses and consumers are expected to be able to withstand these rate hikes. Many analysts continue to suggest that central banks can hike rates quite a bit without affecting credit conditions, especially given the excess liquidity in the markets. Many businesses continue to be in good shape financially, with solid balance sheets and excess cash reserves, so defaults on business loans are expected to be low. Household wealth also increased at all income levels during the pandemic, and delinquency levels on consumer loans still remain at record lows, suggesting the potential for resilience as interest rates rise.[2]

4. Equity markets have performed well in past rising rate environments. Investing theory suggests that interest rates and stock prices move in opposite directions, as stock prices reflect the present value of future earnings: the higher the interest rate, the less future money is worth today. However, history has shown that markets can perform well during rising rates.[3] One market strategist determined that the S&P 500 Index returned five percent in the six months following the first rate hike of past recent cycles, despite initial volatility.[4] Other studies support positive equity market performance during rising interest rate environments (chart).

S&P 500 Performance When 10-Year Treasury Yield Rises By One Percent or More

Start	End	Starting Yield	Ending Yield	S&P 500
Jul '12	Oct '18	1.5%	3.2%	127.2%
Jun '03	May '06	3.3%	5.1%	39.1%
Oct '98	Jan '00	4.5%	6.7%	39.5%
Oct '93	Nov '94	5.3%	8.0%	2.2%
Jan '87	Oct '87	7.1%	9.5%	6.7%
May '83	Jun '84	10.4%	13.6%	−1.5%
Jun '80	Sep '81	9.8%	15.3%	11.4%

https://fortune.com/2021/03/08/stock-market-today-risks-interest-rates/

5. More recent data points to slower economic growth, which may slow the pace of hikes. Recent economic data has been mixed to start the year, painting a slowing economic picture. With the challenge of slower economic growth, and with emerging uncertainties from the geopolitical situation in Europe, it is likely that central bankers will be cautious in the pace of tightening, which may help to temper potential market volatility and may allow time for financial markets and economies to adjust.

1. www.money.cnn.com/1998/09/29/bizbuzz/briefcase/; 2. www.wsj.com/articles/u-s-households-took-on-1-trillion-in-new-debt-in-2021-11644342925; 3. www.bloomberg.com/news/articles/2022-01-23/u-s-stocks-historically-deliver-strong-gains-in-fed-hike-cycles; 4. www.ca.finance.yahoo.com/news/what-happens-to-the-stock-market-when-interest-rates-rise-115245445.html; www.forbes.com/sites/kristinmckenna/2022/01/24/how-do-stocks-perform-when-interest-rates-rise/

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