Market Shrugs Off “New Normal” of Rising Interest Rates

To the surprise of almost no one, the Federal Reserve announced this week that it would raise short-term interest rates and offered greater details of its plans to shrink its $4.5 trillion portfolio of bonds and other assets, which it expects to start later this year. The Fed said it would increase its benchmark federal funds rate by a quarter percentage point to a range between 1% and 1.25%. This is now the fourth interest rate increase since June 2006. The central bank also signaled one more rate increase later this year if the economy performs in line with its projections.

U.S. markets were little changed following the announcement. The Dow Jones industrial average rose 0.2% on Wednesday, a new all-time high. The S&P 500 slipped 0.1% and the Nasdaq Composite lost 0.4%.

In addition to the interest rate increase, the Fed revealed that it would start reducing its balance sheet—its holdings of Treasuries and mortgage securities—gradually by allowing a small amount of net maturities each month. Since the Fed had stopped buying these assets in October 2014 it has continued to reinvest the proceeds of maturing assets to maintain the portfolio’s size.

Initially, it would start by allowing up to $6 billion in Treasury securities and $4 billion in mortgage bonds to mature without reinvestment and eventually let those amounts rise each quarter. The limits would ultimately rise to a maximum of $30 billion a month for Treasuries and $20 billion a month for mortgage-backed securities.

As the markets showed following the rate increase announcement, investors and traders are not scared of rising interest rates. Ultimately, the Fed increasing rates is a sign that the economy is improving, which would benefit the stock market. Solid job gains have lowered the unemployment rate to 4.3%, although inflation is still running below the 2% Fed target. As The Wall Street Journal pointed out, the key is for the Fed to communicate its intentions and plans to avoid the 2013 “taper tantrum” when confusion over the Fed’s plans to slow down asset purchases roiled the market. As Fed Chair Janet Yellen said during the news conference following the Fed’s two-day policy meeting, “The plan is one that is consciously intended to avoid creating market strains and to allow the market to adjust to a very gradual and predictable plan.”

While the Fed indicated it would raise rates again this year, the market is less sure, given the persistent weakness in inflation. As of Friday morning, the CME Group’s FedWatch tool put the likelihood of a rate hike at the December Federal Open Market Committee (FOMC) meeting at 47.3%. It is not until the March 2018 meeting that the odds of rates moving above the current 1% to 1.25% range rise to greater than 50% (57.1%).

If you look to the bond market, there is also growing concern about the strength of the U.S. economy. The yield premium between the 10-year Treasury note and the two-year note shrank on Wednesday to the smallest since September while also approaching its lowest levels since 2007, according to The Wall Street Journal. This falling premium is also known as a flattening yield curve, which is often a signal of slowing economic momentum.

However, as investors, it doesn't pay to try to time the economy or the market. In the long run, as history has shown time and again, U.S. stocks will rise. The key is to have a well-diversified portfolio with allocations that will benefit from all phases of the economic cycle. This also means having a long-term perspective to get you through periods of economic uncertainty and weakness.

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