Interest Rates on the Rise -- What's Driving the Fed's Policy Now?

The Federal Reserve raised short-term interest rates by a quarter percentage point again on June 14, bringing the benchmark federal funds rate to a range of 1% to 1.25%.1 This is the third such increase in six months, and current indications from the Fed point toward one more rate hike this year with more gradual increases beyond 2017.

Indeed, the Fed's actions signal renewed confidence in an economic recovery that, while sluggish at times, has cut the unemployment rate to 4.3% -- its lowest point in 16 years -- and added jobs for 80 consecutive months.

Speaking at a press briefing following a Federal Open Market Committee (FOMC) meeting, Federal Reserve Chairwoman Janet Yellen stated, "We continue to expect that the ongoing strength of the economy will warrant gradual increases in the federal funds rate to sustain a healthy labor market and stabilize inflation around our 2% longer-run objective."[1] She went on to say that "the median projection for the federal funds rate is 1.4% at the end of this year, 2.1% at the end of next year, and 2.9% at the end of 2019."[1]

A Strengthening Economy and Monetary Policy

Indeed, the Fed's actions signal renewed confidence in an economic recovery that, while sluggish at times, has cut the unemployment rate to 4.3% -- its lowest point in 16 years -- and added jobs for 80 consecutive months.[2] Economic growth estimates remained largely unchanged in June with real (i.e., inflation-adjusted) GDP forecast at a median of 2.2% for 2017 and dipping slightly to 1.9% by 2019.[1]

What is less clear in the eyes of Fed policymakers -- and a factor that will no doubt continue to be watched closely -- is the path of inflation, which has weakened somewhat in recent months. According to Yellen, the near-term drop in inflation may have been caused by "one-off reductions in certain categories of prices, such as wireless telephone services and prescription drugs."[1] As a result, the Fed has reduced its estimate for inflation to 1.7% from 1.9% for the year, however the FOMC "still expects inflation to move up and stabilize around 2% over the next couple of years."[1]

Shrinking Its Balance Sheet

In addition to increasing short-term interest rates, the Fed announced that it will also begin selling off the $4.5 trillion in government-issued debt it purchased during and after the financial crisis to help buoy the flagging economy. In her remarks, chairwoman Yellen stated "Provided that the economy evolves broadly as the Committee anticipates, we currently expect to begin implementing a balance sheet normalization program this year."[1]

This "normalization program" will reduce the Federal Reserve's holdings of Treasury securities, agency debt, and mortgage-backed securities in monthly increments with an initial cap of $6 billion a month from maturing Treasuries and $4 billion a month from agency debt and mortgage-backed securities. These caps will increase at three-month intervals over 12 months until they reach a maximum of $30 billion per month and $20 billion per month, respectively.

In a separate announcement the FOMC stated the reductions will continue at the maximum rates until it is determined that "the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively."[3]

Guidance for Investors

How might these actions by the Fed affect your investment portfolio? Consider the following takeaways.

Stocks. Rising interest rates may go hand in hand with an expanding economy -- and that can result in strong stock market performance. However, rising interest rates also mean companies have to pay more to borrow money, potentially reducing their earnings.

Higher interest rates can also have an effect on consumer spending, causing individuals to forgo purchasing big-ticket items, such as cars and homes. Reduced demand can affect the bottom line of companies in all related industries.

Bonds. Since rising rates cause bond prices to fall, existing bonds tend to be worth less, as comparable, newly issued bonds are typically paying a higher rate. Investors who want to sell their older bonds usually must offer them at a reduced price.

Still, rising interest rates do have a plus side. Investors may be encouraged to put more money into bonds. And barring default, holding bonds until maturity ensures that bond investors will have their principal returned.[4]

Stick to Investing Basics

Indeed, rising interest rates can affect different asset classes differently. Investors may want to consider addressing changes in interest rates by holding a diversified mix of asset classes (e.g., stocks, bonds, or cash alternatives, such as U.S. Treasury bills).[5] While diversification does not guarantee against a loss, it may potentially reduce your exposure to risk.

If you are trying to gauge the impact of rising interest rates on your investment portfolio, remember that rates tend to move in cycles, as does the overall economy. Rather than let today's headlines drive your investment strategy, consider maintaining a long-term perspective and talk to your financial advisor about your goals.

[1]Transcript of Chair Yellen's Press Conference, June 14, 2017.

[2]CNN Money, "Fed hikes interest rates and brightens economic outlook," June 14, 2017.

[3]Board of Governors of the Federal Reserve System, "FOMC issues addendum to the Policy Normalization Principles and Plans," June 14, 2017.

[4]Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

[5]Cash alternative investments may not be federally guaranteed or insured and it is possible to lose money by investing in cash alternatives. Returns on cash alternative investments may not keep pace with inflation, so you could lose purchasing power.