Executive Summary

- The U.S. Federal Reserve began raising short-term interest rates in December 2015—the first rate hike since 2006. Small increases in the federal funds rate are unlikely to cause steep declines in bond, stock or real estate investments, although short-term volatility may occur.
- The current environment of low inflation and moderate growth suggests that future Fed rate hikes are likely to be modest in amount and frequency, which may lessen the impact on bonds and real estate, and could be beneficial for stocks.
- Actively managed exposure to a range of bond sectors may help reduce the impact of rising rates on bond investments over the long term.
- For equity investors, history has shown that when inflation is low, Fed rate hikes typically have had a positive effect on equity prices, despite the potential for market volatility early in the cycle.
- Commercial real estate performance has often been resilient during periods of rising rates. Economic and job growth are likely to support strong demand for real estate and the potential for attractive returns, despite lower expected property appreciation.
The effect of rising interest rates on bonds, stocks and real estate

Background

The Fed
The fed funds rate—the key U.S. short-term interest rate benchmark—was 5.25% in June 2006. Since the credit crisis of 2007–08, it has remained in a range of 0%–0.25%. On December 16, 2015, the Fed raised the target rate by 0.25% to a range of 0.25% to 0.50%. We expect future rate increases to be modest in amount and frequency.

The 10-Year Treasury
The 10-Year Treasury, a key fixed-income benchmark, serves as the basis for most retail lending rates, including mortgages. The 10-Year Treasury has been in a declining trend for the past 30 years but is expected to rise slowly in response to the Fed’s action.

Turning point
The U.S. economy has recovered from the Great Recession, and the Fed feels confident it can withstand rate increases—a process the Fed refers to as “normalizing.” Intermediate and long-term rates, which fluctuate with the bond market, will likely move up as well.

Bonds

Yields and prices
When interest rates go up, bond prices typically go down. However, we believe the effects of rate increases will be less dramatic than in the past. The Fed has indicated rate hikes will be modest and will occur at a measured pace. Moreover, rate normalization is long overdue for fixed-income investors, who will benefit from higher income.

The pace of recovery
Bond markets have tended to recover relatively quickly from rate hikes. In fact, when rates have been low but increasing, short-term losses reversed over medium-term time frames. Trying to time the market by moving out of bonds may cause more damage than changes in interest rates.

Strategies
While interest rate increases are likely to be moderate, they will have an impact on fixed-income investments. Higher-yielding bond sectors, which have tended to outperform in past rate-hike cycles, may help cushion the impact.

Stocks

Economy
Despite recent volatility in the equity markets, the U.S. economy continues to grow at a slow pace, which may bode well for equities in a rising-rate environment.

Inflation
History has shown that when inflation is low, as it is currently, Fed rate hikes have typically had a positive effect on equity prices, despite the potential for volatility in the period immediately after a rate increase.

Strategies
High dividend-paying stocks, such as REITs and Utilities, outperformed over the past several years but suffered losses in 2015 in anticipation of rising rates. Sectors that may benefit include Technology, Health Care and Industrials.
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Real Estate

Sector resilience
Analysis by TIAA showed that since 1978, commercial real estate returns were often stable or rising during periods of rising rates. Furthermore, our research shows that property capitalization rates—a key indicator of valuation—do not necessarily move in lockstep with changes in 10-year Treasury yields.

Economy
The outlook for real estate depends to a great extent on economic conditions, which are favorable, with continued economic growth and low inflation in the forecast. While property appreciation will likely slow in 2016, operating income is expected to remain strong and growing, supporting the potential for attractive returns relative to other asset classes.

Strategies
Real estate can play an important role in investor portfolios, offering the potential for current income, diversification2 and attractive long-term returns. With forecasts of stronger economic and job growth, commercial real estate prospects remain bright in 2016 despite rising short-term interest rates.

Consult your financial advisor
Questions about rising interest rates, asset allocation or other investment-related concerns? Check with your financial advisor.

1. TIAA-CREF, “Positioning bond portfolios for rising interest rates,” Fall 2015. Past performance is no guarantee of future results, and there is no assurance that bonds will perform similarly if interest rates rise sharply from current levels.

2. Diversification does not guarantee a profit or protect against loss.

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