The effect of rising interest rates on bonds, stocks and real estate

Executive Summary

The federal funds rate is the overnight rate for loans between banks and other depository institutions. The Federal Reserve establishes a fed funds target rate, which influences all other interest rates in the U.S. economy.

- The U.S. Federal Reserve (The Fed) is continuing to raise short-term interest rates at a moderate pace in response to stronger economic and job growth. 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.
- We believe the expected moderate size of rate increases 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.

Background

The Fed

The federal funds rate—the key U.S. short-term interest rate benchmark—was 5.25% in June 2006. During the financial crisis, the rate fell to near zero in December 2008 and remained in a range of 0%–0.25% until 2015. The Fed adopted two 0.25% rate hikes in December 2015 and December 2016. A total of three rate hikes are expected in 2017, with two more expected in 2018. This scenario would raise the Fed funds rate to a target of 1.25% to 1.5% by the end of 2017, and 1.75% to 2% by the end of 2018.

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 yield has declined for the past 30 years, reaching a low of 1.4% in July 2016. More recently, the 10-year yield climbed to a high of 2.6% in March 2017 before falling to about 2.2% at the end of May on lower inflation expectations. We project the 10-year yield could reach 2.75% by the end of 2017.

A strengthening economy

The U.S. economy has recovered from the Great Recession and is growing stronger. The Fed feels confident the economy can withstand additional rate increases—a process the Fed refers to as “normalizing.” Intermediate and long-term rates, which fluctuate with the bond market, are moving up gradually 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. We expect rate increases to continue in 2017 and 2018 as the economy continues to strengthen and inflation rises. 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.[1] 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

Although stocks have risen to new highs in 2017, they may benefit from modestly faster economic growth that can support higher corporate earnings.

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 real estate investment trusts (REITs) and utilities, have suffered the most since rates began to climb. The technology and consumer discretionary sectors seem likely to benefit from the changing environment, as do U.S. small-cap stocks given their largely domestic revenue streams. However, international stocks may outperform U.S. stocks due to their lower valuations and higher earnings growth potential.

Real Estate

Resilience with rising rates

Commercial real estate performance has often been resilient during periods of gradually rising interest rates and moderate economic growth. Economic and job growth are likely to support sustained demand for real estate and the potential for attractive returns, but with moderate expected property appreciation.

Economy

The outlook for real estate is favorable with expected continuing economic growth, low inflation and a healthy balance in commercial property market conditions. The economy is likely to support continued growth in operating income and potential for attractive returns compared to other asset classes. However, property appreciation is likely to be more modest as interest rates rise.

Strategies

Real estate can play an important role in investor portfolios, offering the potential for current income, diversification[2] and attractive long-term returns. With forecasts of continuing economic and job growth, commercial real estate prospects remain promising in 2017, although returns are likely to be lower and closer to long-term historic averages.

Consult your financial advisor

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

TIAA

1. TIAA, “Positioning bond portfolios for rising interest rates,” December 2016. 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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