Experts Still Uncertain on Interest Rates

By Lee Barney EDITORS@ASSETINTERNATIONAL.COM | September 03, 2015

It should benefit long-term investors when interest rates start ticking up, but some distressing client circumstances could coincide with a rate hike.

Asset managers and retirement plan advisers say it's still hard to pin down exactly when the Federal Reserve will raise the Federal Funds Rate from its current target of 0 to 25 basis points.

Resurgent market volatility in the last week of August led some observers to question whether the Federal Reserve should raise rates after nearly seven years of easy credit policy. One thing is clear: the same uncertainty is helping to drive continued volatility in both the fixed-income and equity markets.

Some short-term negative consequences will come along with an increase in the Federal Funds Rate, if and when it does happen. For example, fixed income investments may decrease in terms of trading value, and debt will get more expensive for companies looking to generate and invest capital. Fortunately, according to Bob Andres, chief investment officer of Andres Capital Management in Berwyn, Pennsylvania, investors are not looking at a sharp, painful rate hike.

"The concept of interest rates going up dramatically is not in the cards," Andres says. "People have been dealing with low rates for a long period of time, and, unfortunately, that will continue for a lot longer than people think. We are not going to see the 10-year Treasury reach a 4% to 5% interest rate any time soon, because we do not have that strong an economy or inflationary pressures."

The Federal Reserve would like to raise rates to continue the normalization process still unfolding in the wake of the most recent financial crisis. Many people are concerned that the Fed's low rates have allowed equity prices to inflate since 2008 and 2009, especially given some latent GDP weakness and other growth-oriented factors.

"That is why you have heard the Fed talk about raising rates for so long, but they haven't done it," Andres says.

Just like last year, when the stock markets fell in December and the Federal Reserve held off on raising rates, the current stock market declines may keep the Fed at bay a little longer, agrees Jason Brady, head of fixed-income investing at Thornburg Investment Management in Santa Fe, New Mexico. "We have been expecting the Fed to raise rates for the past six years, but they won't because global growth isn't that great and U.S. inflation is low," Brady says. "At most, the Fed will raise rates by 25 to 50 basis points in the short term."

The Fed also is leery of further strengthening an already strong dollar, says Mike Chadwick, president of Chadwick Financial Advisers in Unionville, Connecticut. "We have to think about the global currency war," Chadwick says. "Most countries are trying to devalue their currencies to be more competitive. If we were to raise rates, the dollar will become a lot stronger and we will become less competitive."

The uncertainty over when the Fed will raise rates is clearly fueling some of the volatility in the markets, says James Macey, senior vice president and portfolio manager at Franklin Templeton Solutions in New York. "Uncertainty is the worst possible thing for the markets," Macey says. "The uncertainty over the timing of a September or later rate rise is paralyzing the market right now."

However, if the Fed were to raise rates, historically the move has benefited equity investors, says Macey. "Equities do well in rising rate environments," he says. "If you were to look at tightening cycles since 1955, where there have been at least three consecutive rate increases, on average, the S&P 500 rose 6% in the 12 month period following the first tightening."

A Fed tightening will increase stock market volatility "but not erode stock market performance," agrees Rich Saperstein, chief executive officer of HighTower. "It would signal to the markets that the Fed is confident in the growth of the U.S. economy and corporate earnings."

If rates rise, this will create an opportunity for investors to buy equities, says Chad Carmichael, principal and practice lead of U.S. retirement at North Highland in Charlotte, North Carolina. He is of the opinion that the Fed might increase rates this month. "We are seeing consumer consumption, lending rates and job creation pick up—all pointing to a strong U.S. economy and consumer, which are good for investors," Carmichael says. "Retirement plan participants should be using volatility as points of inflection for their asset allocation, making sure they are appropriately allocated and maximizing their contributions."

For fixed-income investors, "rising rates would have a really big impact," Chadwick says. "Fixed-income investments generally have an inverse relationship to interest rates. Typically, when interest rates go up, the value of fixed-income investments go down. Not all bonds are safe today. A lot are overpriced by as much as 15% to 30%."

In this environment of flat interest rates and the anticipation of a rise in interest rates, HighTower Treasury Partners expects continued volatility. "Obviously we are in an environment where it appears that at some point, the Fed will raise interest rates," says Steve Bogner, managing director at HighTower in New York. "As a trusted adviser to retirement plans, two years ago, we started suggesting to our retirement committees that they move out of longer duration fixed income and inflation-protected funds to mitigate some of the potential risk of a rising rate environment."

In addition, HighTower has "gone out in front of the volatility that could occur in the bond market by advising plans not to offer risky bond funds," Saperstein adds.

Brady says rising rates would benefit retirement plan participants and retirees, particularly with respect to their fixed-income holdings.

“While a lot of people who own fixed-income assets might look at rising rates as a negative, for participants and retirees, rates going up is a good thing because it creates a lot more income potential in the marketplace,” Brady says. “In the late 1990s, 10-year Treasuries delivered 4% after inflation, and you could build a solid portfolio around that. Today, the 10-year Treasury is in the 25 basis point to 50 basis point range. If we can get yield to rise to 3%, with inflation at 1.5%, that gives you in very broad terms a net 1.5% yield, which is quite a change and would be beneficial for retirement investors.”

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