Fed Rate Hike: What Does It Mean for Your Portfolio?

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Here we go again: The Federal Reserve just raised the federal funds rate target for the second time so far this year. The move was widely expected—the economy has been gaining traction, unemployment is at historical lows and Fed policymakers had suggested a hike was coming. Now that it has happened, how might it affect your investments? Here are five things to keep in mind.

1. Short-term fixed income investments are strongly influenced by the federal funds rate. The federal funds rate is an overnight bank-to-bank lending rate that the Fed can use to implement monetary policy. Put simply, when the Fed wants to tap the brakes on economic growth, it can raise the fed funds rate, making it more expensive for banks to borrow money from each other. Banks tend to scale back lending in turn, slowing the economy. (Conversely, the Fed can lower the rate when it wants to boost growth, allowing more money to circulate in the economy).

Because it's a short-term rate, any changes tend to have the strongest impact on short-term instruments, such as deposit accounts, money market funds, Treasury bills, short-term bonds and short-term bond funds. When the federal funds rate is rising, it generally means that bank savings accounts and money market funds will pay a higher yield over time. As new Treasury bills and short-term bonds are issued, they should pay higher yields, too.

2. Intermediate- and long-term bonds may be less affected. That's not to say intermediate-term bonds (generally, those maturing in five to seven years) or long-term bonds (maturing in 15 years or more) won't feel it. But rates typically don't rise in lockstep all along the yield curve.

"One thing to keep in mind that when the Fed raises short-term interest rates, it doesn't mean all interest rates go up," says Kathy Jones, senior vice president and chief fixed income strategist at the Schwab Center for Financial Research. "Long-term rates tend to be affected by other factors, as well—like the prospects for growth, inflation expectations and generally the supply and demand for bonds that have attractive yields on a global basis. Not all rates are going to respond to a fed funds hike in the same way."

3. The effect on savings accounts, CDs, mortgages, floating-rate notes and other products will vary. For example, rates on short-term certificates of deposit (CDs) probably will rise along with the federal funds rate, but not all CD rates will rise by the same amount. Longer-maturity CD rates may behave like intermediate- or long-term bond yields.

Adjustable-rate mortgages are usually tied to short-term rates, and if so they can be expected to rise. However, fixed-rate mortgages generally track 10-year Treasury bond yields, and won't necessarily move higher just because short-term rates do.

Meanwhile, although income from floating-rate notes should rise over time, it doesn't always happen right away. Additionally, many floating-rate investments, like bank loans, have "caps" or "floors" that limit how much their coupon payments can change.

4. Stock markets typically rise during the earlier stages of rate-tightening cycles. But the Fed's moves on short-term rates aren't the only factor driving stocks. How longer-term interest rates move also affects stock market performance—as does the shape of the yield curve.

As things stand now, the yield curve is flattening as short-term interest rates rise in the face of a strong economy, while longer-term rates lag slightly due to the moderate pace of inflation. Stocks have historically performed well in such conditions—and in some cases have continued to do so even after the yield curve has inverted (i.e., when short-term rates have surpassed longer-term ones). Inversion is generally seen as a warning sign for the economy.

It's typically only when monetary policy becomes overly restrictive that a recession grows more likely and stocks suffer. In any case, recessions have historically come *after* the Fed has finished hiking rates, not during a rate-hiking cycle. The period immediately before the recession showed up—starting up to six months prior—has tended to be the worst for the U.S. stock market in terms of returns. But we aren't there yet.

"The conditions for a more rapid pace of rate hikes—inflation trending higher and job growth still robust—are favorable for stocks for now," says Liz Ann Sonders, senior vice president and chief investment strategist at Charles Schwab & Co. "Although inflation is often seen as a bogeyman for stocks, it's not typically until inflation overheats that trouble ensues."

However, we are arguably late in the economic cycle, and are seeing tighter financial conditions overall for the first time in this rate-tightening cycle. So even if the economy and/or inflation are not yet overheating, it does suggest an era of heightened volatility.

5. Rising rates underscore the importance of diversification and rebalancing. Rising rates can be a market game-changer, or at least a signal that economic and market conditions are changing. A well-diversified portfolio can help keep you from being overexposed to areas of the market that may not perform as well in the future as they have in the past and also help ensure that you're appropriately weighted to investments that may now outperform.

Periodic rebalancing can help, too, and here's why: Over time, "winning" investments will gain in value and take up a larger portion of your portfolio, while other investments will shrink in comparison. That can leave your portfolio unbalanced—and potentially increase your risk when market conditions change. Rebalancing involves periodically buying and selling assets to bring your portfolio back to your current desired asset allocation.

"Investors can't control interest rates, credit spreads, currency values or Fed policy," Kathy says. "But they can control what they own and how they position their portfolios for a range of potential outcomes."

What you can do next

- Make sure your portfolio is diversified and aligned with your risk tolerance and investment timeframe. Want to talk about your portfolio? Call a Schwab Fixed Income Specialist at 877-566-7982, visit a branch or find a consultant.
- Explore Schwab's views on additional fixed income topics in Bond Insights.

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Past performance is no guarantee of future results and the opinions presented cannot be viewed as an indicator of future performance.

Diversification and rebalancing strategies do not ensure a profit and do not protect against losses in declining markets.

While the market value of a floating rate note is relatively insensitive to changes in interest rates, the income received is highly dependent upon the level of the reference rate over the life of the investment. Total return may be less than anticipated if future interest rate expectations are not met.

The S&P 500 index is a market-capitalization-weighted index that consists of 500 widely traded stocks chosen for market size, liquidity and industry group representation.

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