Interest rates headed up, but how fast will they rise?

Most analysts and advisers expect a gradual climb tempered by economic performance

Dec 11, 2015 @ 12:00 pm

By **Jeff Benjamin**

With the **Federal Reserve** Board of Governors expected on Wednesday to introduce its first interest rate hike in nearly a decade, financial advisers, analysts, and the financial markets in general are already looking ahead to the next hike, and to the one after that.

"This will be part of what I have previously called the loosest tightening in the modern history of the Fed," said Mohamed El-Erian, chief economic adviser at Allianz SE.

"It will be positioned as a component of a very shallow interest rate cycle, with an ending point below historical averages," he added. "And Fed officials are likely to stress that this will not be your usual hike-at-every-meeting cycle; instead it will involve stop-and-go characteristics."

In essence, as the Fed moves off of what is essentially a short-term rate of zero, while still saddled with an unprecedented $5 trillion balance sheet leftover from **multiple quantitative easing programs**, there will be more focus on what the Fed says than what the

Fed does.

"The bond market will still be there the day after the rate hike," said Kashif Amed, a financial adviser and president at American Private Wealth.

"We know this is going to happen," he added. "And it's not going to be an Earth-ending event."

It is so **widely anticipated that the Fed will raise rates by 25 basis points on Wednesday** that the specific percentage is described as already "baked in the cake" of the financial markets.

An *InvestmentNews* survey of financial advisers found that 89% of respondents are confident the Fed will raise rates at next week's meeting, and 65% of respondents said they made no recent adjustments to client portfolios in preparation for the move.

Will the Fed raise rates at Dec. 15-16 meeting?

Created with Highcharts 4.1.6YesNo

However, nearly a quarter of respondents don't feel the Fed should raise rates at this time, and 68% believe the rate hike will trigger increased volatility in the stock and bond markets.

Of those advisers that have been tweaking client portfolios in anticipation of the Fed move, 53% reduced fixed income exposure, 37% increased cash weightings, 36% increased allocations to alternative investments, 30% increased equity

Have you made any changes to client

portfolios in anticipation of a rate hike?

Created with Highcharts 4.1.6YesNo

Source: *InvestmentNews* Research

exposure, 12% decreased equity exposure, and 2% increased fixed income exposure.

Because of the noteworthy nature of the first Fed hike since 2006, some market volatility would be considered normal, but as a rising-rate cycle starts to take shape, the biggest impact for most investors will be felt in their bond portfolios.

Todd Rosenbluth, director of mutual fund and ETF research at S&P Capital IQ, said some bond fund investors could be surprised to learn how much duration risk they're taking on.

“If investors have only been paying attention to the returns of their bond funds, and not paying attention to the underlying duration exposure, there might be a wake-up call,” he said. “If you own a bond fund and you don't know its duration, you're going to find out how rate-sensitive it is when rates start rising.”

Bond prices **typically move in the opposite direction of interest rates**, and the degree of such moves can be calculated using a bond portfolio's duration.

As an example, if rates climb by a percentage point, a portfolio with an average duration of five years will likely decline by five percentage points.

For investors and financial advisers, the key element will be the pace of the so-called Fed liftoff, which is an area where the markets could find some uncertainty, and uncertainty usually leads to volatility.

For instance, at the Fed's September meeting, the median projected rate at the end of 2016 from the 17 voting members of the Fed board was 1.375%, which would suggest regular rate hikes over the next year.

But the bond market, based on futures trading activity, is targeting a year-end 2016 Fed rate of 0.835%, which is a considerable gap that could narrow when the Fed board posts its updated projections on Wednesday.

“The market is still looking for a very gradual pace of hikes, and we'll find out on Wednesday if the Fed has moved toward the market or not, but somebody has to be right,” said Gary Pzegeo, head of fixed income at Atlantic Private Wealth.

The Fed has been nothing but forthright in preparing the markets for its upcoming rate hike, but that doesn't resolve the reality of all the **forces still working against high interest rates at this time**, including sluggish growth in wages and the economy, virtually no sign of inflation, plunging energy prices, and a global economy that has foreign central bankers generally moving in the opposite direction of the **Federal Reserve**.

“We think the rate hike is justified because the U.S. economy has improved to a level that warrants something more than emergency-level Fed policy, but the outlook still is mixed,” said Terry Sandven, chief equity strategist at U.S. Bank Wealth Management.

“The biggest risk is not that the Fed moves, but that they don't move, because that will imply a no-confidence vote in the economy,” he added. “But the marquee value alone of the first rate hike in nearly 10 years could bring some volatility because of the change in trend.”

Another possibility is that the Fed exposes a hawkish mode, suggesting that the economy is ready for an aggressive tightening cycle.

“A big risk out there that people might be missing is that the economy is stronger than everyone thinks, and we end up getting more rate hikes, sooner,” said Scott Randy, an adviser with Kuhn Advisors.

In the context of both the global and domestic economic environments, an aggressive rate-hike policy seems unlikely to Scott Couto, head of distribution for Fidelity Institutional Asset Management.

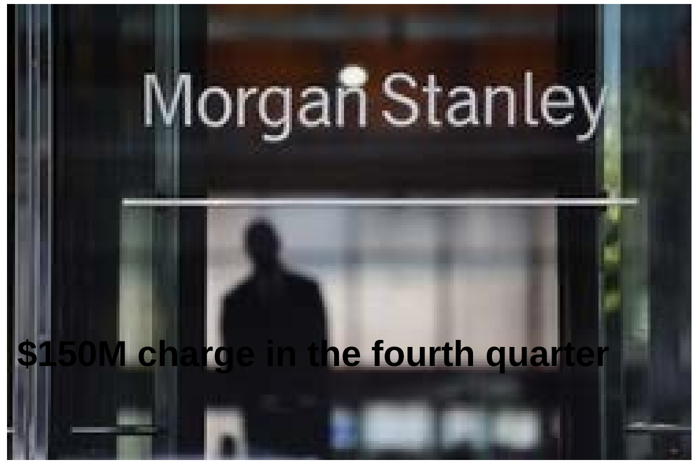
But he also believes calling the move “symbolic is too strong a word for a very important institution like the Federal Reserve.”

“In order for Fed to go on a rate-hike cycle, you'd have to see inflation, and we'd have to be later in the economic cycle," Mr. Couto added. "The first rate hike is not the sign of bad news for bonds overall; it signals mid-cycle growth, which is typically not the time to bail out of fixed income, or to move into defensive equity sectors."

For added comfort, he pointed out that throughout the entire 40-year rising rate period through 1981, the worst one-year decline for intermediate-term bonds was 5%, and there was never a five-year period when the category posted a loss.

In terms of adjusting client portfolios ahead of the Fed's first hike, Paul Schatz, president of Heritage Capital, said it is too late because the markets have already adjusted to the upcoming hike.

"At this point, you're either positioned or you're not," he said. "There's nothing left to do, unless you're expecting some new trends to emerge before Wednesday."



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If you look at the Dec 2015 delivery the anticipated rate for 31 December 2015 is 0.22% (100.00 – the contract price of 99.78 = an expected delivery rate 31 December 2015 of 0.22)

If the market believed the Fed will raise rates on the 16 December the anticipated delivery rate for 31 December should be much higher than 0.22%, contract price 99.78, contract value $917, it should be more like 0.35% contract price 99.65, contract value $1,458, if the full increase was priced in 0.50% contact price 99.50, contract value $2,083.

Underlying options say the same thing, the options market is telling us the hike on Wednesday is a 30 to 1 shot.

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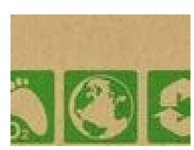

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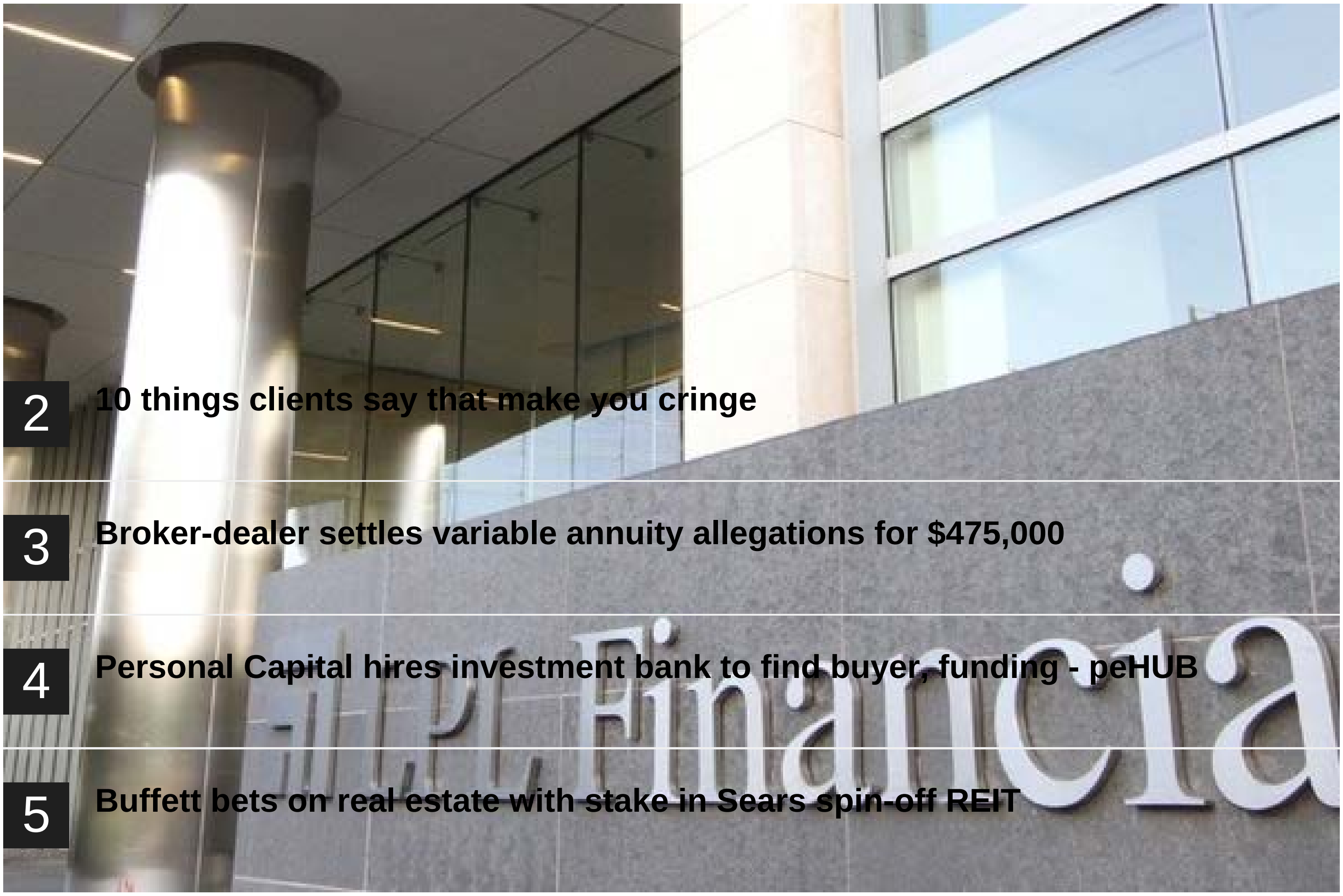

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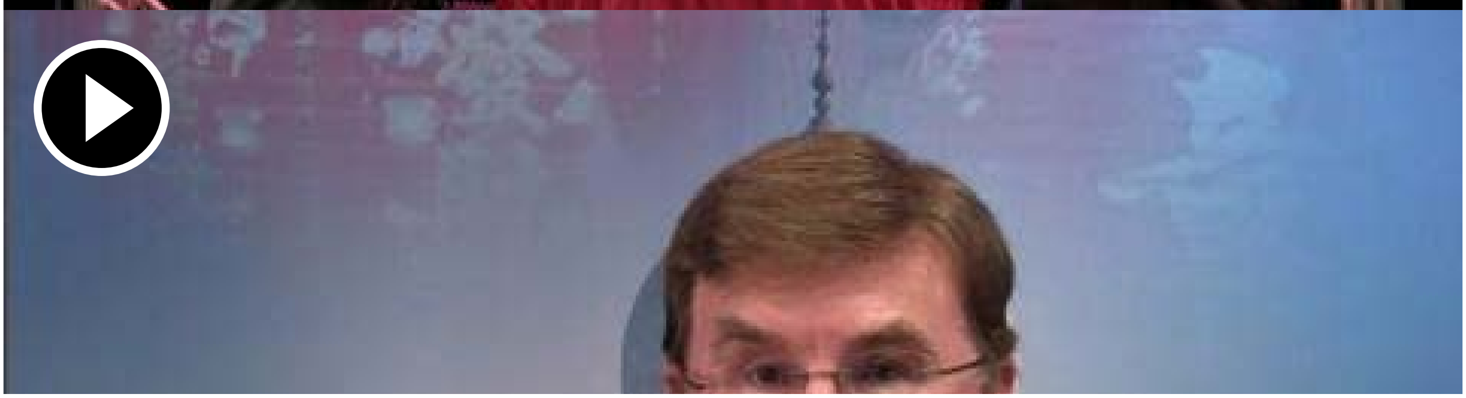

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