Eagle Strategies LLC

Investment Strategies to Consider in a Rising Interest Rate Environment

After inflation reached its highest levels in nearly four decades in November, the Federal Reserve (the Fed) took action in an effort to curb inflation. During its December 2021 meeting, the Fed agreed to end its bond-buying stimulus program two months earlier than originally planned—in March 2022 instead of June 2022.

This move will allow the Fed to begin increasing interest rates sooner, and more quickly, as three rate increases are projected for 2022, with additional increases expected in 2023 and 2024. The stock market rose at the news, as the move was predicated on solid economic growth. Fed Chair Jerome Powell noted, “This is a strong economy, one in which it is appropriate for interest rate hikes.”

Uncertainties for investors remain, most obviously in connection with the Omicron coronavirus variant and its potential economic impact. Yet, one thing is clear: **interest rates will be going up for the foreseeable future.** With this change in the Fed's policy, now is a good time to prepare your portfolio to help withstand and—even benefit from—these future rate increases. Here are some strategies to consider:

BOND STRATEGIES

Different asset classes have historically reacted to interest rate hikes in different ways. What does the end of the Fed's bond-buying stimulus and rising rates mean when it comes to bonds? Although bond prices generally fall when rates rise, certain types of bonds can still play an important role in your portfolio, potentially providing stability and generating a steady income stream.

Short- and Medium-Term Bonds: Bond maturity can have a big impact on how bond prices will react to interest rate hikes. Shorter duration bonds are less sensitive to rate increases than longer-maturity bonds that lock into rising rates for longer time periods. Therefore, it may be a good idea to reduce any long-term bond exposure in your portfolio.

High-Yield Bonds: Investors may also want to consider allocating a portion of their portfolio to high-yield bonds, which are less sensitive to rate increases than lower-risk bond investments. High-yield bonds often gain in value as the economy expands – which may present opportunities for investors seeking bond income, which has been difficult to find in recent years when rates have been at historical lows.

Treasury Inflation-Protected Securities (TIPS): TIPS are indexed to the Consumer Price Index (CPI), which measures the costs of goods and services. This adjustable interest rate is less sensitive to rising interest rates than other fixed-rate investments. You can buy individual TIPS or invest in an Exchange-Traded Fund (ETF) that owns a broad portfolio of TIPS.

Floating-Rate Investments: Floating-rate bonds can also be good investments in a rising-rate environment as they reduce portfolio volatility by “floating” in sync with the market rate. There are also mutual funds and ETFs that invest in floating-rate instruments such as mortgage-backed securities, collateralized debt obligations, and leveraged loans.

Looking Beyond Bonds

Certain industries and sectors perform better than others in a rising interest rate ecosystem. Keep these investment segments in mind when reviewing your portfolio in advance of upcoming rate hikes.

Commodities and Commodity-Focused Stocks: Commodities and related stocks tend to perform well in higher inflation and rising rate environments. This includes not only the Energy and Materials sectors, but also the Industrials sector, where machinery is needed to mine the commodities.

Financial Services and Bank Stocks: Higher interest rates allow for bigger margins and more profits on loans and financial transactions. The U.S. Dollar generally does well against foreign currencies in a rising rate scenario since higher rates attract foreign capital.

Value Over Growth: Periods of higher rates have historically signaled a suitable time to invest in value stocks (so-called because they are a relatively good value based on fundamentals such as earnings, dividends, or revenue). This makes sense considering that all four of the these sectors—Energy, Materials, Industrials, and Financials—are integral components of the value index.

Real Estate: Rising interest rates are also good news for the real estate sector (including real estate investment trusts or "REITs") since home prices tend to rise with—and even outpace—interest rates. This holds true for rental income properties, which can pass along higher owner expenditures in the form of higher rents.

While a rising rates environment can pose challenges to investors, the Fed is introducing these rate increases as a corrective measure to offset the corrosive effects of inflation. There are ways that savvy investors can profit from rising rates, and as always, it is important to maintain focus on long-term investing goals.

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