

Rising Interest Rates: The Downside of Economic Recovery

Over the last several years, investors have grown accustomed to historically low interest rates. Ever since the Federal Reserve Board's target fed funds rate--the rate at which banks lend to one another--hit a high above 19% in mid-1981, the long-term direction of rates has been downward. In the last decade, the Fed's data* shows the target rate has never been much higher than 6%. And since December 2008, the Fed has kept it at a previously unheard-of level between 0.25% and zero to try to ensure that credit would be available to promote economic recovery.

Because bond prices typically rise when interest rates fall, that decline in yields has produced a bull market in bonds over the last decade. But what happens when the trend reverses? Even if they continue to remain relatively stable for a while, ultra-low interest rates have nowhere to go but up. When the economic recovery begins to show signs of strength, at some point the Federal Reserve Board will begin to raise the target rate again. When that happens, bond prices also will begin to reverse their long-term direction.

Here are some factors to consider in anticipation of a future with rising interest rates.

Bond maturities: when short is sweet

When interest rates rise, longer-term bonds typically feel the impact the most. In an extended period of rising interest rates, bond buyers become reluctant to tie up their money for longer periods because they foresee higher yields in the future; the later the bond's maturity date, the greater the risk that its yield will eventually be superseded by that of newer bonds. As demand drops and yields increase to attract purchasers, prices fall.

There are various ways to manage that impact. If you own individual bonds, you always have the option of holding them to maturity; in that case, you would suffer no loss of principal unless the borrower defaults. Bond investments also can be laddered. This involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As each bond matures, it can be reinvested in an instrument that carries a higher yield. Laddering also can be used with certificates of deposit (CDs).

If you own a bond fund, you can check the average maturity of the fund's holdings, or the fund's average duration, which takes into account the value of interest payments and will generally be shorter than the average

maturity. The longer a fund's duration, the more sensitive it may be to interest rate changes.

Rising rates and other assets

Higher interest rates often are an attempt to prevent rising prices. When prices go up, purchasing power goes down, including the purchasing power of a bond's fixed interest payments. That can make bonds less attractive to buyers. However, not all investments are hurt by higher prices. For example, commodities such as oil and wheat typically do well in inflationary periods; in fact, increases in commodity prices are often what trigger a bout of inflation. If you're primarily interested in the overall value of your portfolio rather than a regular income stream, your financial professional can help you explore whether you should consider diversifying into asset classes that tend to benefit from inflation and that might help counteract the potential impact of falling bond prices.

Though bonds are affected most directly, equities aren't necessarily immune to rate increases. Though many companies borrowed money in recent years to take advantage of low rates and postpone the need to issue bonds for some time, those that haven't may see their borrowing costs increase, which could affect their bottom lines. Even those that squirreled away cash could be hit when they return to the bond markets eventually. Also, if interest rates rise to a level that's competitive with the return on stocks, that could reduce investor demand for equities.

Higher rates aren't all bad news

For those who've been diligent about saving, or who have kept a substantial portion of their investments in cash, higher rates could be a boon. Savings accounts, CDs, and money market funds are all likely to do better at providing income than they have in recent years. The downside, of course, is that if higher rates are accompanied by inflation, such cash alternatives might not keep pace with rising prices. And bear in mind that a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1 per share, it is possible to lose money investing in a money market fund.

**Source: Federal Reserve Statistical Release Historical Data for Fed funds rate weekly since 1954.*

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