Rising rates have not meant poor stock returns

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When the U.S. Federal Open Market Committee meets, September 25–26, policymakers are all but certain to raise short-term interest rates 25 basis points to 2.00%–2.25%. Recent economic data make it an easy call: GDP was running at over 4.00% on an annualized, inflation-adjusted basis in the second quarter; the unemployment rate is at a 17-year low of 3.90%; and the Federal Reserve's preferred inflation gauge, the core personal consumption expenditures index, finally is hovering near its 2.00% target.

A hike next week would put short-term rates about 75 basis points below where we see them topping out for the current economic cycle, at around 2.75%–3.00%.

How will this upward trajectory for short-term rates affect investors?

Higher yields on cash are good news for savers

Since the Fed started raising rates in December 2015, investors have channeled just north of a net $60 billion into money market funds. That coincides with an increase in average yields from almost zero to roughly 1.90% for Treasury money market funds and to well over 2.00% for prime money market funds.

Inflows may well accelerate as rates rise further.

For bond investors, the picture is more mixed

Shorter-term rates are rising after being at or near historic lows for almost a decade. Longer-term rates have remained more anchored, however. They are influenced less by Fed action than by investors' long-term expectations for growth and inflation, which remain subdued despite the short-term cyclical upswing we're currently experiencing.

Bond investors might cringe at our outlook for rising rates but, in truth, the short-term pain experienced when rates rise is offset by higher future returns. We also expect fixed income assets to provide increased portfolio diversification benefits as interest rates continue to normalize.

What about stocks and rising rates?

The data may surprise you.

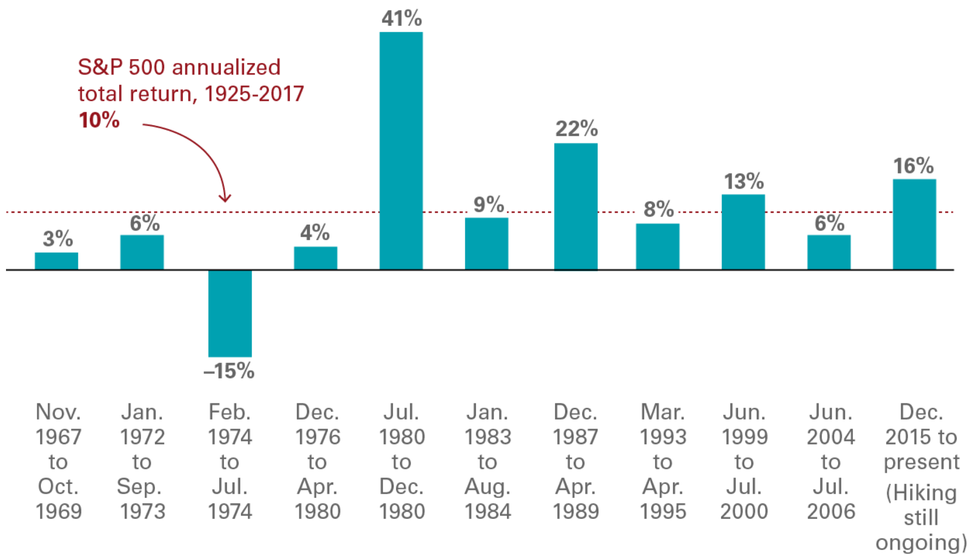
Many investors believe that rising interest rates are a harbinger of poor stock returns, and they have some solid reasons for thinking that. Higher rates make bonds relatively more attractive versus stocks. And higher rates slow overall economic growth, which weighs on corporate profits and stock prices. Financially savvy investors might also note that higher interest rates lower the value of future corporate earnings, thereby reducing their present value.

The historical research we've done, however, doesn't show a pattern of falling stock prices during rate-hiking cycles. In fact, hiking regimes often take place when the economy is performing strongly and earnings growth is robust, and therefore stocks tend to perform respectably during those periods.

As the graphic below illustrates, in the 11 periods of rising rates we looked at over the past 50 years, stock market returns were positive in all but one of them. And even including the –15% return for the period in 1974, the return of stocks across those periods was in line with the 10% average for stocks from 1925 through 2017.

Rising interest rates do not equal poor equity performance

During the **11 periods of rising rates** that have occurred over the past 50 years, **annualized total returns** have been broadly positive and in line with historical averages.



Note: Return for latest hiking period is as of August 24, 2018.

Sources: Vanguard calculations based on data from Bloomberg, St. Louis Federal Reserve database, and Moody's DataBuffet. All equity calculations represent the S&P 500 Index.

The bottom line

The global interest rate environment is becoming less accommodative, and the Fed has been leading the way among major central banks with seven consecutive hikes so far in the current tightening cycle.

I've noted that this shift doesn't necessarily argue for a tactical tilt toward bonds or stocks. And at any rate, tilting would amount to trying to time the markets, which research has shown time and again is a strategy that often doesn't work out well.

One upside to staying the course is that higher short-term rates translate into additional income for investors from their bond portfolios. Another is that their fixed income allocation should provide greater ballast for the more volatile equity component of their portfolios.

Notes:

- All investing is subject to risk, including the possible loss of the money you invest. Bonds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.
- Past performance is not a guarantee of future results.

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