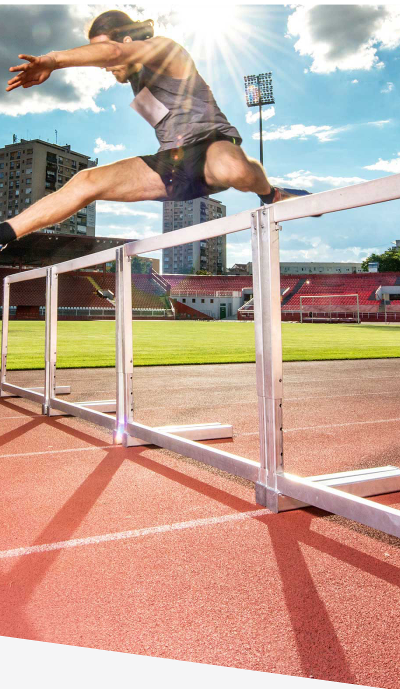

How interest rates could increase: a timeline

July 23, 2021

As the economy recovers, fixed-income investors are anticipating higher interest rates. The key question is when and which rates will change — and how to position portfolios accordingly.

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Interest rates are a primary driver of fixed-income returns, so investors need to know when — and how — to prepare for rate changes. The Federal Reserve has various direct and indirect levers to guide interest rates. But rates also change because of market expectations. Here are three events to keep in mind:

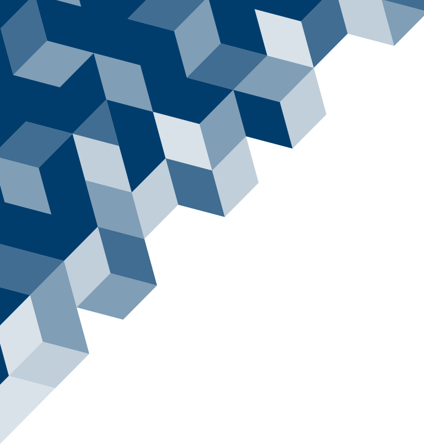
Market expectations drive rates: The yield curve steepens

Yield curve steepening means that the difference between long- and short-term interest rates increases. It can happen when longer term rates rise faster than shorter term rates, or when shorter term rates fall faster than longer term rates (see our latest chart). When the long end rises faster, it's usually because investors are concerned about inflation and expect the Fed to hike interest rates in the future — as was the case earlier this year. In response, fixed-income investors usually reduce their demand for long-term bonds and so their prices fall. This results in higher yield for long-term bonds because of the inverse relationship between price and yield.

The Fed acts to raise rates: Taking off the training wheels through Fed tapering
Tapering refers to the gradual reversal of the Fed's quantitative easing — a policy of purchasing long-term government bonds to push down long-term interest rates. It indicates that the economy is on firmer footing. As opposed to directly setting an interest rate level, the Fed moves rates higher by reducing its own demand for bonds, which causes prices to fall. Again, the inverse relationship between price and yield results in higher yield for long-term bonds. The timing, pace and scope of tapering can take different forms (the Fed purchased bonds in many fixed-income asset classes as part of its quantitative easing program) and it can vary which fixed-income asset classes it exits. While tapering generally has the effect of increasing the yield on long-term bonds, how the Fed does it matters for fixed-income investors.

The Fed acts to raise rates: With the economy on solid ground, the Fed raises the overnight rates
The Fed has been clear about the key measures it will be watching — including maximum employment — to determine when to raise the fed funds rate (interest-rate banks charge one another for overnight loans). A higher fed funds rate results in a higher cost of borrowing for banks, which they then pass on to individuals and businesses who want to borrow. Unlike the previous examples, this more directly impacts shorter term interest rates, which increases the attractiveness of savings instruments (e.g., CDs).

How to position portfolios
Uncertainty, fluid economic conditions and an extended timeline for Fed action will mostly likely cause interest rates to rise in different ways at various times. It's important for investors to stay flexible and understand the risks of individual bonds across the yield curve. Investors could benefit from an active approach to structuring a fixed-income portfolio that's able to identify positions that can potentially take advantage of opportunities as they emerge.



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