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360 Insights

New Year, New Policy: Higher Rates Likely Ahead

By Jonathan Scheid, CFA, AIF®

The economy continues to gain steam, the unemployment rate continues to fall, and inflation is rising. All of this seems to point to a recovered economy. So then why is the Federal Reserve still keeping interest rates low?

How We Got Here

The Fed has a dual mandate of maintaining stable prices (i.e., inflation) and maximum employment. To help influence the rate of inflation and employment, the Fed has several tools – including increasing or decreasing the interest rate banks are charged for borrowing money, bank lending requirements, and asset purchases – to influence the economy and consumer behavior.

As the pandemic began and the economy started to shut down in early 2020, the Fed moved quickly to support it. In just two months, the federal funds rate (i.e., the interest rate the Fed sets for banks to lend money to each other overnight) went from over 1.5% to less than 0.25%, where it remains today. This makes the price of bank loans less expensive. Additionally, the Fed announced it would buy hundreds of billions of dollars of government bonds and mortgage bonds to help lower interest rates on longer-term borrowing.

Where We Are Now

The support the Fed provided, along with fiscal stimulus packages, helped the economy successfully navigate the depths of the global pandemic. Now, unemployment is close to where it was before the pandemic started and inflation, as we've all experienced, is the highest we've seen in over 30 years.

While the Fed still has some concerns about the employment situation (e.g., women are under-employed as a percentage of where they were pre-pandemic), the central bank recognizes that it needs to shift its policy from a very accommodating one. To that end, the Fed already announced that it is going to slowly reduce the amount of money it spends on bonds – in a process called tapering – and it plans to stop buying bonds altogether sometime in the first half of 2022.

After the bond-buying stops, the Fed's focus shifts to the level of interest rates. This will likely be one of the hot topics of 2022. Fed members are currently debating when and how quickly interest rates should increase in an effort to moderate the economy and slow the rate of inflation. The information they provide to the public suggests that some members want to see interest rates start to increase in 2022, and almost all members want interest rates to go up in 2023. If inflation remains elevated, pressure will grow for the Fed to raise interest rates sooner.

What This Means for Us

We're now clearly at the start of a change in policy at the Federal Reserve. This change in policy likely means the end of historically low interest rates. Given how accommodative the Fed has been, it doesn't seem inclined to turn the temperature of the economy from hot to cold in one quick motion. Like past rate-hike cycles, we'll be in the warm zone for a while.

Rising rates has its pluses and minuses. On the plus side, higher interest rate levels mean we may see increases in our cash savings accounts, money market funds and other savings accounts. On the negative, rising interest rates typically send bond prices lower and create more price uncertainty for stocks.
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Fear of (Market) Heights? Don't Panic

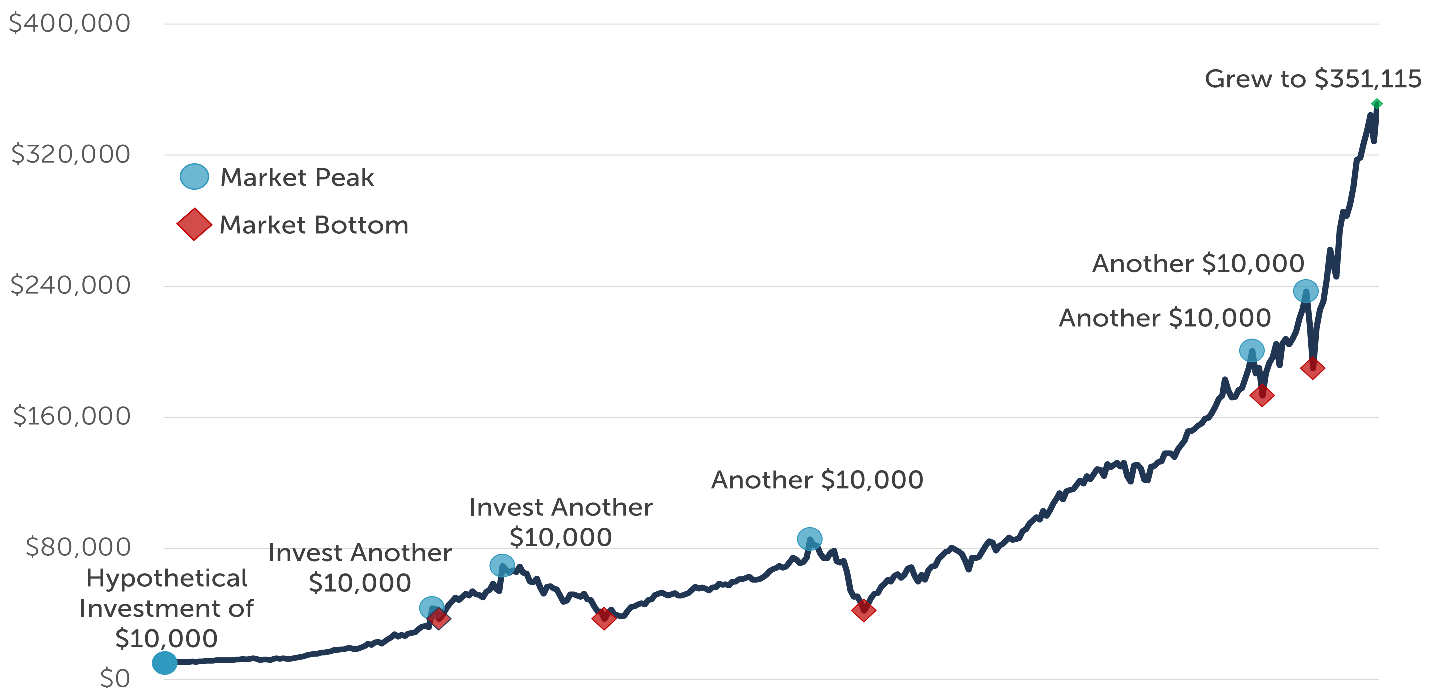
By Daniel Campbell, CFA

> More people have lost money waiting for corrections and anticipating corrections than in the actual corrections. – Peter Lynch[1]

Deciding to invest additional money can be scary when markets are close to their all-time high. Maybe that's something you experienced a lot last year, as the U.S. stock market broke its record no less than 60 times in 2021.[2] When this happens, perhaps a sell-off always feels imminent and by investing we risk watching hard-earned savings decline in value. And most investors would prefer to buy into the market after a dip to get a better value on their initial investment. So when markets are close to their high, it's natural to ask whether we should wait for a correction before we invest new money.

But even before we consider whether to invest, we need to understand our timeline for using the funds. If you intend to use the money for spending throughout retirement, then your timeline is likely long, and for investors with a longer timeline, investing additional money into stocks is appropriate even if the market is at or close to its high.

To illustrate this point, consider a hypothetical investor who we know has the absolute worst market timing. Let's go back 30 years and assume our investor starts by investing $10,000 in stocks. They then invest another $10,000 at various points over the next three decades, but in each case, they manage to buy in at the market peak. In other words, this investor only invests at market highs prior to big drops. The chart shows their experience.



Returns over the last 30 years for a hypothetical investor who started with $10,000 invested in U.S. stocks, and then only invested again immediately before a market downturn of 10% or more. Over this time, the U.S. market returned 10.2% per year, and the investor with the worst timing earned 9.3% per year.[3]

This hypothetical investor turned a total investment of $60,000 into more than $350,000 over the 30-year period. They survived five significant declines in which their portfolio fell by over 10%, dropping an average of once every six years. Each market decline averaged roughly 11 months, followed by another 21 months to recover. In other words, after a big investment, our investor waited an average of three years before they started seeing a positive return on their investment (and it was almost seven years after 2008). However, despite investing at peaks, our investor's portfolio still grew significantly.[4] While it's no guarantee for the future, history has shown that the question isn't *if* stock markets will go up but *when*.

This example only looks at investing in one asset class – U.S. stocks. Although U.S. markets were at highs frequently in 2021, tempered valuations in other markets suggest better investment opportunities exist internationally. No matter which valuation ratio we choose, the U.S. is more expensive than over 70% of other developed markets and more expensive than 90% of emerging markets.[5] Your portfolio manages the risk of market declines by investing across multiple economies, both developed and emerging. It then balances stock risk with high-quality fixed income to add more stability and to help ensure the declines aren't more than you can tolerate.

No one knows which direction markets will move tomorrow. And anyone invested in the stock market should expect to see declines in their portfolio. That's part of investing. But just because stocks are at their highs doesn't mean they won't go higher – the U.S. markets proved that over 60 times in 2021.

We expect stock markets to be up over the next 20 years, which means that, on average, we expect any given year, month, or day to have a positive return. And if we expect a positive return, we should invest new money immediately. Although that can be scary, history has shown that even if we have the worst timing and invest at market peaks, having a long investment horizon allows us to stay invested until it recovers. Success isn't determined by when you invest; it's determined by sticking with your financial life plan and how long you choose to stay invested.

1 Peter Lynch is most known for his management of the Magellan fund at Fidelity, which returned nearly 30% per year under his tenure from 1977 through 1990. Source: Fidelity

2 As measured by the daily closing price of the Russell 3000 Index. Source: FTSE Russell

3 Source: Morningstar Direct. Based on the monthly returns of the MSCI USA Index from November 1, 1991, through October 31, 2021, the last full month of returns available at the time of writing. The investor return of 9.3% per year represents the investor's internal rate of return (IRR) over the period, which includes the impact of having more cash invested immediately prior to the downturn.

4 We can contrast this experience with the investor who has "perfect" market timing and invests instead at the very bottom after the 10% decline. Despite the perfect timing, that investor would have earned 10.6% per year, only 0.4% more than the total market over the period.

5 Source: Morningstar Direct, using MSCI country index data. Valuations as of September 30, 2021.

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Fortunately, our investment preference for short- to intermediate-term bonds, which are less sensitive to changes in interest rates than long-term bonds, should help reduce the impact of rising rates on our bond positions. For stocks, rising rates may translate into more stock market volatility (i.e., ups and downs in stock prices), so effective diversification will truly be our friend as rates start to rise.

As we've all seen multiple times over the past few decades, the Fed will influence interest rate levels to increase or decrease the overall speed of economic growth. With low unemployment and rising inflation telling us the economy may be moving too fast, it seems like the right time for the Fed to begin nudging things in a new direction.

Source: Federal Reserve Economic Data, Federal Open Market Committee. For informational and educational purposes only and should not be construed as specific investment, accounting, legal, or tax advice. Certain information is based upon third-party data which may become outdated or otherwise superseded without notice. Third-party information is deemed to be reliable, but its accuracy and completeness cannot be guaranteed. IRN-21-3030

Refresh Your Perspective on Money and Happiness

By Alex Kluesner

Eighteenth-century Swiss philosopher Jean-Jacques Rousseau said, “The money you have gives you freedom; the money you pursue enslaves you.” He clearly believed that money alone can’t guarantee happiness. Many other philosophers, business moguls, and philanthropists both before and after his time would also agree. But even centuries later that valid and valuable perspective doesn’t always stop us from struggling with money’s role in achieving a deep, abiding sense of satisfaction in life. If you find yourself wondering whether a larger bank account or better investment returns would bring you (more) happiness, consider taking some time to think about how those things are and are not related.

It’s true that money and wealth can provide a certain amount of happiness and wellbeing by helping us satisfy our base-level needs. But past that subsistence level, your needs – which are driven primarily by lifestyle preferences – are different than those of others; you might need more or less wealth than someone else to achieve the feeling of contentment that comes with comfortably maintaining your lifestyle. This concept has spurred academics to produce a welter of socio-psychological and financial studies to determine whether an increase in wealth beyond what you require to satisfy your essential needs will result in a similar increase in happiness. For instance, a 2010 study conducted by Nobel Prize-winning economists Daniel Kahneman and Angus Deaton claimed that the relationship between annual income and happiness was highly correlated up to $75,000 a year but then lost significance above that threshold.[1] Even though such research doesn’t offer a hard-and-fast rule for every person and every situation, the most recent addition to the literature, a 2021 study from Matthew Killingsworth, shows that wealth does continue providing more happiness above that $75,000 income level, but at a diminishing rate.[2] The takeaway for us is that, whatever our own actual number may work out to be, the pursuit of wealth comes with an inflection point. In other words, the psychological toll of generating additional wealth at a certain point may be greater than any temporary happiness gained from it.

If you agree that the overall relationship between money and happiness eventually becomes non-linear, then what should you do with money you do have? The beauty of money is that it can buy many things, and while you can’t order happiness off Amazon (some might argue that point), it can buy flexibility. A certain level of wealth – when spent wisely – can afford you the opportunity to do almost whatever you want whenever you want with whoever you’d like. It can buy you more time with friends and family. It can allow you to quit your job tomorrow and pursue a truer passion. It gives you freedom to do the things that make you happiest. And it’s important to remember that you don’t need an immeasurable amount of wealth to do these things as long as you prioritize what truly matters to you: charitable giving, family vacations, or planning for the next generation, just to name a few. Following this framework could make you feel wealthier than any amount of money ever could.

Your long-term financial plan is one mechanism to help translate your money into happiness. Your advisory team works diligently with this idea in mind when helping you select an investment portfolio and implement financial planning strategies to meet your life goals and desired milestones. So, instead of being hyper-focused on the pursuit of happiness by way of accumulating more wealth or chasing higher investment returns, be mindful of your current assets, long-term financial plan, and how both can deliver financial freedom and greater flexibility.

1. Daniel Kahneman and Angus Deaton, “High income improves evaluation of life but not emotional well-being,” Proceedings of the National Academy of Sciences 107, no. 38 (September 2010): 16489-16493.

2. Matthew A. Killingsworth, “Experienced well-being rises with income, even above $75,000 per year,” Proceedings of the National Academy of Sciences 118, no. 4 (January 2021): e2016976118.

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