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The Fed, interest rates and your investments

In 2006 the Federal Reserve Board continued its careful watch of federal fund rates in hopes of keeping inflation in check. The *federal funds rates* is the interest that banks pay each other when borrowing federal money for short periods. This rate is important because by increasing or decreasing the rate, the Fed can impact—over time—practically every other interest rate charged by U.S. banks.

About the Fed

The Federal Reserve Board is the U.S. equivalent of a central bank. It was founded by Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system.

The Fed's duties fall into four general areas: (1) conducting the nation's monetary policy; (2) supervising and regulating banking institutions and protecting the credit rights of consumers; (3) maintaining the stability of the financial system; and (4) providing certain financial services to the U.S. government, the public, financial institutions and foreign official institutions.

More specifically, the Fed's mandate is "to promote sustainable growth, high levels of employment, stability of prices to help preserve the purchasing power of the dollar, and moderate long-term interest rates."

The Federal Open Market Committee (FOMC) is the policy-setting arm of the Fed. Typically, the FOMC meets eight times a year. It is at these meetings that the decisions are made as to how monetary policy should be implemented.

The impact of interest rates on the markets

In recent years inflation has remained in check. But economists are on both sides of the fence as to whether it will continue to do so. What *is* certain is that investors and soon-to-be retirees will want to do some long-range planning with higher interest rates in mind.

Typically, a healthy stock market relies on an environment of low interest rates, low inflation and a growing economy. Investors fear interest rate hikes on the theory that higher rates will slow the economy, hurt corporate profits and drive stock prices down.

A rise in interest rates has a more direct impact on bond prices. As interest rates change, the market value of existing bonds changes as well, but in the opposite direction. When interest rates go up, existing bond values go down. When rates drop, existing bond values go up.

Result: The higher bond yields that result from a rise in interest rates often lead investors to abandon the stock market in favor of the bond market, where they can receive potentially higher returns.

Steps to consider

As is often said, past performance is not an indicator of future results. Still, history may serve as a guide when trying to develop a strategy to protect a portfolio or retirement plan account from the market declines that are associated with rising interest rates.

From that perspective, according to an article in *Forbes*, large- and mid-cap companies have fared better than small caps, and the growth style of investing appears to have an advantage over the value style. Information technology and health care stocks have fared well, while telecommunications and utilities have not. And companies with low debt have a competitive advantage over those that may have the need to borrow at a higher cost.

In a rising interest rate environment, investors should avoid getting locked into low rates of return on long-term investments. Short- and intermediate-term bonds and bond funds may be worth considering.

Should a greater portion of a portfolio or retirement plan account be allocated to cash equivalents? When rates rise, the more liquid investments that you own, the less that you will need to borrow for substantial purchases at the higher rates.

There is a downside to this strategy, however. Rising interest rates usually are accompanied by rising inflation. Therefore, if an investor has a long-term horizon, cash investments are likely to have a difficult time keeping pace with inflation.

Let us help you plan

Our investment management specialists devote much time and thought to helping our clients take sensible steps to offset the effects of inflation. Whether you are building assets for the future or investing to maintain your current standard of living, we will be glad to put our experience and knowledge to work for you.

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Any developments occurring after January 15, 2007, are not reflected in this article.