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Get Ready: Interest Rate Hikes Bring Good and Bad

By THE ASSOCIATED PRESS

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CHICAGO (AP) -- The rate hikes are coming! The rate hikes are coming!

Eventually.

Days after the [Federal Reserve](#) seemed to sound the alarm that the era of near-zero interest rates is ending, Chairman [Ben Bernanke](#) tempered those expectations a bit this week. Just because the Fed boosted the rate it charges banks, he told Congress, doesn't mean it will move any time soon to boost broader interest rates too.

Nonetheless, it behooves investors to be ready, regardless whether rate hikes come in the second half of 2010 or not until next year.

Despite what some may think, moving toward higher rates will be good news in many ways.

It's an endorsement of the economy's potential to soon stand on its own without the help of emergency rates. It means yields from CDs as well as savings and money-market accounts at banks won't be minuscule much longer. It could even bode well for certain types of stocks.

But higher interest rates are bad for bonds and may make some other holdings less appealing too, especially once inflation starts rising. So investors should take a close look at what they own and consider making changes.

"It's a wakeup call," says Larry Glazer, managing partner at Mayflower Advisors in Boston. "People need to take a step back and figure out what they're trying to accomplish."

Here's how higher rates could affect your personal finances.

BONDS

Bonds are in line to experience the biggest fallout since they generally move inversely to interest rates. When interest rates exceed the rate on a previously issued bond, the bond's value on the open market drops.

That could be costly for investors who poured more than \$400 billion into bond funds since the start of 2009, according to the [Investment Company Institute](#). Seeking stability, they could instead now be setting themselves up for a fall.

Greg Merlino, a planner with Ameriway Financial Services in Voorhees, N.J., is working to lessen and

reallocate his clients' bond holdings for that reason.

"What we saw last year was people getting out of stocks and into Treasuries, high-grade corporate bonds, extremely 'safe' stuff," he says. "That's where you're going to see some pain once rates move up."

Long-term bond funds could be the most vulnerable.

Yet this doesn't mean to strip your portfolio of all bond funds and other fixed-income investments.

Be wary of being overly invested in bonds and consider reallocating, says Brad Sorensen, director of market and sector analysis for the Schwab Center for Financial Research in Denver. But no one knows where the market will go for certain, so it's important to keep a long-term horizon in mind.

Dan Fuss, a renowned fixed-income manager, knows that patience with bonds can be rewarded. His Loomis Sayles Bond Fund lost 22 percent in 2008 and then rebounded with a 37 percent return last year.

"Bonds don't go up in a rising rate environment. But you can make money in bonds after a couple years' stutter-step," he told the CFA Society of Chicago last week, adding that a downturn in bonds may not last that long.

STOCKS

Overall market returns may be harder to come when the Fed determines it needs to raise interest rates to try to keep the economy from growing too fast. But stocks should still climb.

A Standard & Poor's study of what happened after past rate hikes tells the story: Stocks rose at only a modestly lower rate than the norm.

All told, the Fed has moved 13 times since 1946 to raise rates, usually in a series of increases lasting about 25 months. The Standard & Poor's 500 index has risen a not-too-paltry 6.2 percent on average in the year following the start of the process, according to Sam Stovall, S&P's chief investment strategist.

What's more, some sectors have been big winners over those 12 months following the first rate hike, with technology stocks jumping an average 20 percent higher and health care stocks up 13 percent.

Tread carefully, though. Some sectors have been big laggards when rates rise, notably utilities, financials and materials.

INFLATION

Bernanke professes not to be overly concerned about inflation, so you shouldn't either.

That leaves investors to determine whether [Treasury](#) inflation-protected securities, or TIPS, are a wise buy now or not.

Unlike with many corporate bonds, you can be fully confident that the issuer -- the U.S. government -- will pay you back. The return on these [Treasury bonds](#) is adjusted to eliminate the impact of inflation.

Just be aware the optimal timing for buying TIPS may have passed. So many investors piled into them last year, concerned that heavy government spending would spur inflation, that some advisers consider them too pricey now.

SAVING AND BORROWING

Long-suffering savers can look forward to a time when their money can grow at a decent clip again while sitting in the bank. Currently, rates for one-year CDs are under 1.7 percent, savings and money-market bank accounts often below 1 percent and money-market [mutual funds](#) hovering just above zero.

At the same time, rising rates will make mortgages and other loans more expensive. If you're thinking about buying a home or refinancing an existing mortgage, it might be time to consider locking in those low-low rates.

All these trends are likely to be gradual, and hinge on a Fed decision that still appears months away.

But financial planners like Paul Ahern of WealthTrust-Arizona in Scottsdale, Ariz., are making it a priority to talk with clients about what it all means and prepare for the inevitable.

"The economy's still too uncertain to call, so I don't think they can raise rates just yet," he says. "But we know it's coming."

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