Morgan Stanley Wealth Management

The KP Group at Morgan Stanley

Quarterly Market Commentary

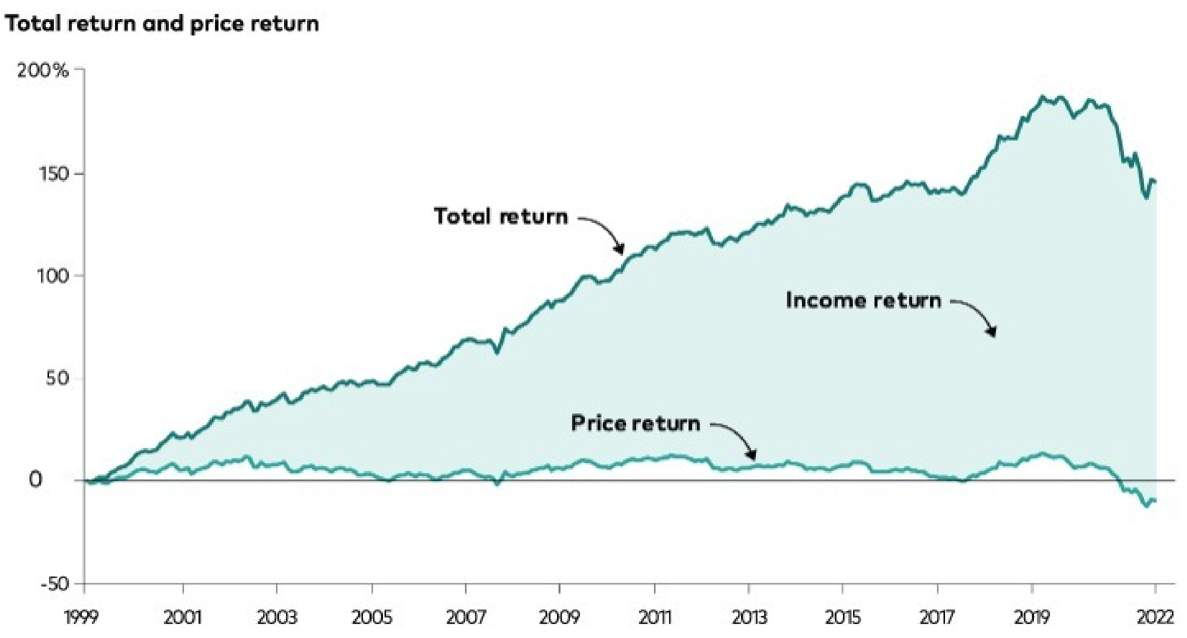
Don't Fear Higher Interest Rates

Unless you have been living under a rock this year, you've probably been inundated with a myriad of news headlines declaring the potential doom-and-gloom that rising interest rates are going to bring to the world economy, stock market and your investment portfolio. As with anything, there are generally two sides of a story but "Yee who screams loudest is often the one heard…" However, that doesn't necessarily mean they are correct. In this letter, we wanted to take the opportunity to discuss, in our view, the impact of rising rates particularly for your fixed income investments.

To help tame inflation, the US Federal Reserve (Fed) raised its benchmark interest rate to its highest level in 15 years – now at the targeted range of 5.00%-5.25% after its May 2023 meeting. While the bulk of Fed rate hikes appear to be in the rearview mirror, the Fed is expected to boost the rate a little more in 2023 (Natixis). Currently the Fed funds rate stands at 5.08%; well off the all-time low of 0.05% in April 2020. But how does this compare to the historical average Fed Funds Rate? Since 1954, the Fed Funds Rate has averaged 4.6%. It has only been since the 2008 Financial Crisis that the economy experienced sustained sub-1% rates averaging 0.75% (FED Reserve). We believe the economy is in far better shape now than it was following the Financial Crisis and can handle interest rates at their current, near historical average levels.

The question may then become, what will happen to your fixed income investments if rates continue to rise? In the short run, when rates rise, bond prices fall, which can cause immediate pain to fixed income investors. However, rising rates are good for bond "income" or coupon returns. Rising rates mean more income, which compounds over time, enabling bond holders to reinvest coupons at higher rates. Overall, higher rates offer the potential for greater income and total return in the future (Natixis). A bond's total return is comprised of two components: price return and income return. Most investors tend to focus solely on price return; however, over the longer term, bond total returns are driven much more by reinvestment of interest income and compounding than by price returns (Vanguard). Our advice is that investors need to look beyond the immediate pain of losses appearing in their quarterly bond portfolio statements to the longer-term upside of rising interest rates.

Price return and total return for U.S. aggregate bonds



Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Notes: Monthly data are from December 31, 1999, to December 31, 2022. U.S. aggregate bonds are represented by the Bloomberg U.S. Aggregate Bond Index in USD. All bond income is assumed to be reinvested. Income return is the reinvestment of coupons and compound interest on the reinvestment.

Source: Bloomberg.

In our view, higher interest rates will benefit most investors over the long term and should be welcomed; particularly those invested in a diversified portfolio. For the past 15 years, we have been in an all-time low interest rate environment which has negatively impacted the benefits of having fixed income in a diversified portfolio and in some cases forced investors to take on more risk than comfortable to achieve their needed returns to sustain themselves during retirement. We are finally starting to see the fixed income allocation do what it was meant to do… provide a stable income/return while offsetting the volatility associated with their equity positions. We do not believe in trying to time the market or the FED for that matter. Instead, we focus on managing our investments and portfolios for the long run and advise our clients to take a similar mindset.

We are always here to answer any questions.

Best Regards,
Carlos and Dane

Sources:

Natixis- Bond Basics: How Interest Rates Affect Bond Yields, May 9, 2023

Vanguard- Why your clients shouldn't abandon bonds, March 6, 2023

FED: FRED Gross Domestic Product & FRED Federal Funds Effective Rate

Morgan Stanley Website

We are thrilled to provide our clients with the most up to date client resources. Navigate to our website to view our special designations, investor resources, and digital wealth tools.

Team Website

Carlos Kuri

Vice President, Financial Advisor, International Financial Advisor, Portfolio Manager

Direct: 713-966-2165

LinkedIn

Dane Pearson

International Financial Advisor, Financial Advisor, Portfolio Manager

Direct: 713-499-2016

LinkedIn

[Signature of Primary Contact]