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Higher Rates, Better Opportunities

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In September, the Federal Reserve raised interest rates for the first time in more than three years. The Fed increased its key rate by 0.25%, bringing its target range to 3.75% to 4.00%.

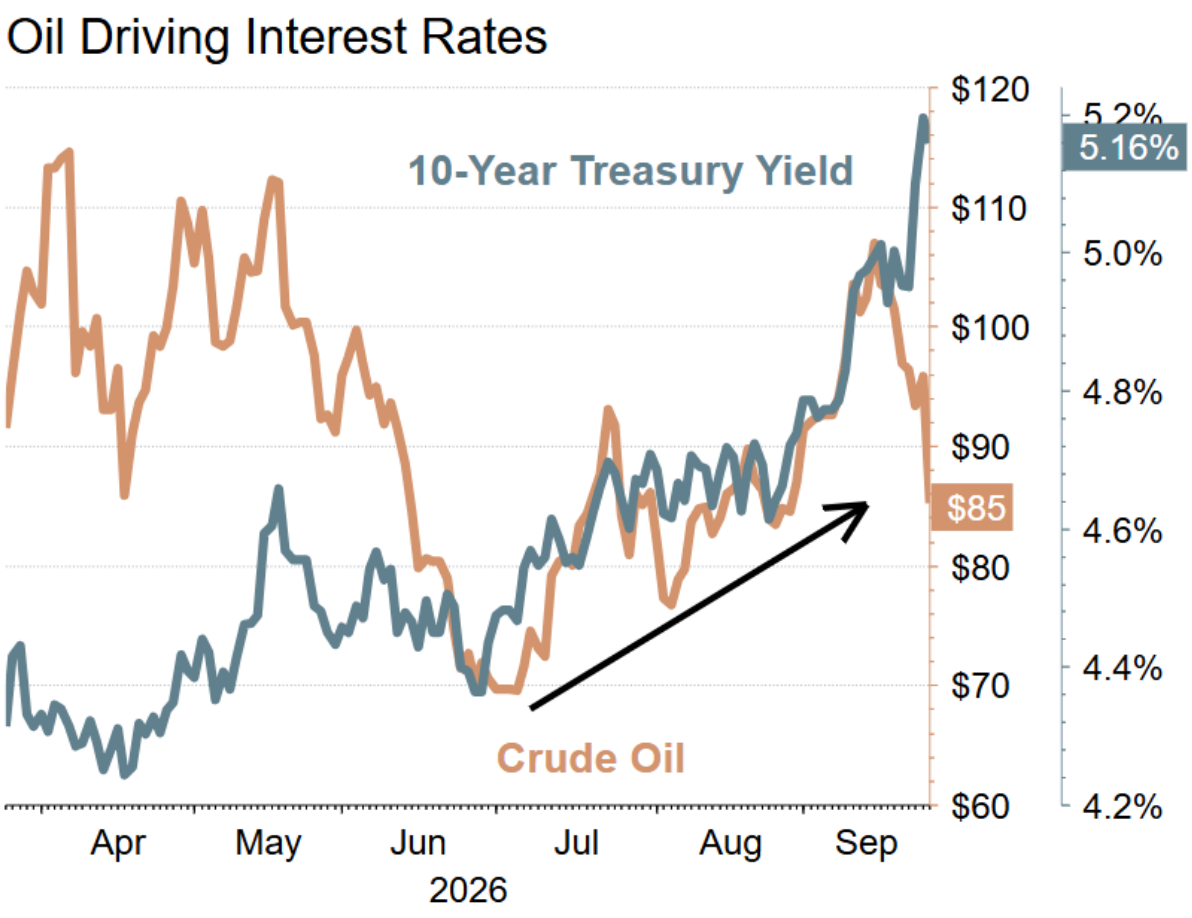
Higher rates can hurt bond prices in the short run. But they can also create better opportunities for investors.

Oil and interest rates are moving together

Over the past three months, oil prices and interest rates have moved closely together. This has been one of their strongest relationships in the past 30 years.

Higher oil prices can raise the cost of travel, shipping, and making goods. This may keep inflation higher and put pressure on interest rates.

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Source: LSEG Datastream / Aurum Group at Wealth Enhancement

Over the past two weeks, it seems this correlation has broken as interest rates went up and oil dropped. There must be other factors driving interest rates.

Inflation Above Target

The latest price rise looks different than the episode in 2021-22. While prices remain above the 2% core inflation target in total, less categories are contributing to the rise. Airfares, insurance, and software are examples of services with the largest impact on price levels.

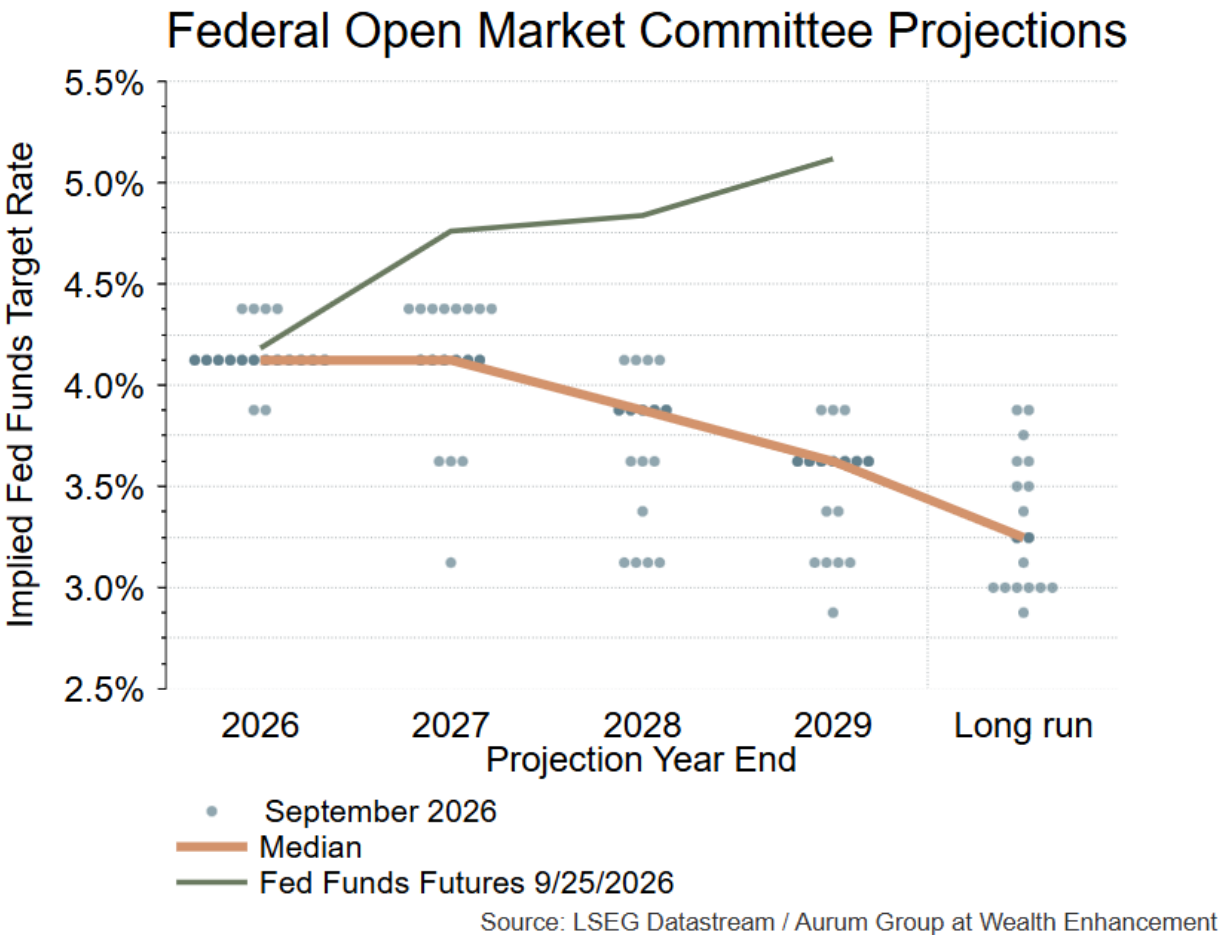
The persistence of service business raising prices along with challenges in shipping goods are also factors. In turn, this puts pressure on the Federal Reserve to act to fulfill its mandate of price stability.

What the market expects

The Fed's "dot plot" shows where each Fed member thinks interest rates may go. The orange line in the chart shows the middle Fed forecast. The green line shows what financial markets expect.

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The market currently expects a higher path for rates than the Fed's median forecast at certain points. If those expectations fall, bond yields could decline and bond prices could rise. Of course, rates could remain high if inflation stays firm.



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A stronger starting point for bonds

The biggest change is the starting point. Base interest rates near 5% allow investors to earn meaningful income before taking much added risk.

Investors may earn even more by owning high-quality corporate bonds. This extra yield is called a credit spread. It is the added income investors receive for lending to a company rather than the U.S. government.

For example, a bond might begin with a base rate at 5% and add a credit spread of 1-3% on top of it. The added income can be attractive, but it also comes with added risk. Credit quality still matters.

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Municipal bonds may be especially useful for investors in higher tax brackets. Their interest is generally exempt from federal income tax, although individual circumstances vary.

Municipal bond yielding 4% or 5% has a tax-equivalent yield of 6% to 8%, depending on the tax bracket. In addition, state specific bonds can make the tax benefit even larger for some investors.

Higher yields create opportunities to harvest tax losses, improve credit quality, and lock in income for longer. These are all prudent portfolio actions our team is considering today. While no one knows exactly where rates go next, today’s bond market offers a much better starting point for income and expected returns.

This information is not intended as a recommendation. The opinions are subject to change at any time and no forecasts can be guaranteed. Investment decisions should always be made based on an investor's specific circumstances. Investing involves risk, including possible loss of principal.