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The Fed is lifting off

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Inflation has been increasing to worrisome levels, and the Federal Reserve is beginning to use the tools in its tool box to try to bring inflation down to acceptable levels. The main tool the Fed uses is changes in the federal funds rate, but it also has other tools, such as its own balance sheet. The Fed has already started the process of increasing rates, but we think it is likely that we will see additional aggressive actions by the Fed this year — including the potential for 50-basis-point rate hikes, or .50%, and quantitative tightening. When the economy grows fast enough to rouse inflation, the Fed can use these tools to increase the cost of borrowing, which could help slow down inflation and spending.

Most fixed income investments struggle in a rising interest-rate environment. As interest rates have increased, the first quarter of this year was one of the worst from a performance perspective for fixed income investors that we have seen in some time. Rising rates tend to have more of an effect on prices of long-term bonds than those with short-term maturities.

While rates have moved higher, risks remain. We look for fixed income volatility to remain elevated in the year ahead. The risk that the Fed makes a policy mistake is heightened. With this backdrop, we favor remaining defensive in fixed income positioning, but as rates continue to rise, the time may come to go on the offense.

Risk considerations

All investments are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors due to numerous factors some of which may be unpredictable. Be sure you understand and are able to bear the associated market, liquidity, credit, yield fluctuation, and other risks involved in an investment in a particular strategy.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates.

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