

Three Cheers for Higher Rates

by Jeremy J. Siegel

To hear the gurus talk, higher interest rates are the stock market's worst enemy. Higher rates, they say, will push bond and stock prices down and slow the economy's growth by slapping higher interest charges on to the shoulders of already heavily indebted consumers.

That's just half the picture. Those who bemoan the end of low interest rates forget they often signal a sick economy. In fact, the low rates of the past several years are a reflection of not only the government's actions to stimulate the economy, but also of the dreadful collapse in productivity that followed the 9/11 terrorist attacks and of the decline of corporate borrowing after the enormous over-investment during the tech boom of the late 1990s.

For every borrower, a lender

When interest rates fall, borrowers benefit, but lenders – including retirees who own bonds and bond funds – suffer. One investment adviser I talked with has elderly clients who are being forced by low rates to liquidate their portfolios at a much faster rate than they planned. His clients will be delighted by higher rates.

What about the negative impact of higher interest rates on bond prices? True, prices will go down. But you won't be affected unless you sell your bonds before maturity. Take a retiree who bought bonds with varying maturities and is now living off the income coupons. Higher rates won't change the income generated by her bonds – they remain what they were. In fact, if rates rise, soon-to-be retirees with piles of cash will be better off because those higher rates will help improve their future cash flow.

Next, there's the fear that higher rates will slam the housing market, which has been a source of much consumer strength. Property prices soared in response to lower rates, but those higher prices forced buyers to take on increased debt – hardly a plus for the economy.

Moreover, the value of your house is different from the value of your other investments. You have to live somewhere, and homeownership is a hedge against changes in the future cost of housing. Only if you own more house than you want to live in – for example, if you plan to downsize – should your home price be considered an important part of your portfolio. While your house may have appreciated handsomely, other property has, too, so you cannot get any extra benefits out of the increase in the price of your home.

Higher interest rates appear bad for investors because we fixate on the market value of our portfolio and not enough on the income that the portfolio will produce in the future. The appreciation in stock and bond prices brought about by lower rates doesn't represent any gain in future income. Similarly, the decline in these asset prices caused by higher rates doesn't cause a fall in future income.

After inflation

All of what I have said applies to real rates, after inflation has been subtracted. Higher interest rates that result from inflation are bad for almost everyone because they do not represent a future increase in after-inflation income. What troubles the stock market is not only higher interest rates stemming from an increasingly optimistic economic outlook, but also higher rates caused by increased inflation – specifically higher oil prices. The uncertain geopolitical outlook does not help.

Federal Reserve Board chairman Alan Greenspan cannot do anything about Iraq and terrorism. But he should raise short-term rates fast enough to prevent higher oil prices from starting a wage-price spiral. Higher short-term rates that slow inflation are a positive, not a negative, for bonds. Thus far, most of the increase in rates we've seen results from a return to profitability in the U.S. economy, and investors should welcome this.

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