Inflation is back. U.S. consumer prices rose 6.2% year-over-year in October, the steepest increase in more than 30 years, as a flood of cheap money surging met consumer demand and supply chain bottlenecks.

Should that pattern continue, it would likely prompt the Federal Reserve to raise short-term interest rates. Tightening the money supply—or in plain English, making money more expensive—could cool the overheated economy and start to bring prices of goods and services back down. But what effect would rate hikes have on stocks? While there are many variables, it's quite conceivable that stock prices could suffer.

The current inflation spike can be traced to the Covid pandemic, which destroyed millions of jobs and disrupted global supply chains, and U.S. policymakers' fears of an ensuing recession. To insulate the economy, Washington unleashed waves of stimulus spending, and the Federal Reserve kept interest rates low while buying up assets such as real estate loans.

Whether rising prices are a temporary phenomenon, driven mostly by shortages of supplies and labor, or a deeper problem rooted in too much money printing, is the subject of debate among economists. But even if the inflation we're seeing now is not deeply rooted, it could still do real damage to the economy. How? By influencing expectations: If businesses assume inflation will keep rising, they'll plan to raise employee salaries, and they'll raise prices to pay for those increases, setting a cycle in motion.

So will the Fed raise interest rates? And if so, when? The agency is currently in something of a bind, because it is tasked both with controlling inflation and maximizing employment. Right now the unemployment rate stands at 4.8%, well about the 3.5% rate of just before the pandemic. By raising rates too soon or too sharply, the Fed could reverse the employment recovery.
The markets' actions reflect a belief that the Fed will indeed start raising rates by the middle of 2022. That's a long way off, and a lot could change. But it's worth looking at the potential impact on markets. The effect of rising interest rates on bonds is fairly straightforward: Rising rates make existing bonds less valuable, since newly issued ones will pay more.

But higher rates can also hurt stocks, by making it more expensive for businesses to borrow money. Costlier credit raises the cost of doing business, potentially lowering corporations' earnings and ability to grow, and thus impacting their stock prices. Fed rate increases also

affect market psychology; when rate hikes are announced, traders might quickly sell off stocks, sending the market down sharply. It's possible that we could see significant drops in certain stocks, while others will prove more durable.

How should investors prepare for the possibility of rate hikes? First, know what you own. Some investments are more vulnerable to rising rates than others. And bear in mind that market dips can be buying opportunities: It's always a good idea to have a "shopping list" of stocks that you can snap up when their prices are attractive. Please don't hesitate to get in touch with us if you'd like to discuss your investments.