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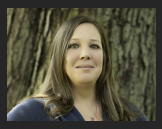
What Fed Rate Hikes Really Mean for Long-Term Investors



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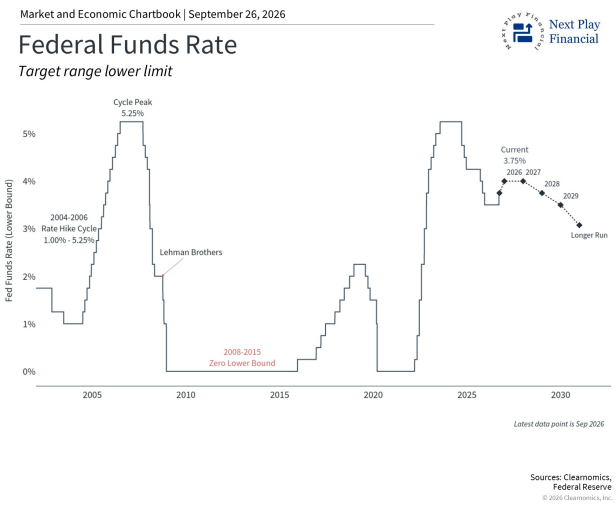
Janet Yellen, the former Federal Reserve Chair, often said that "monetary policy is not a panacea."[1] Much like the common cold, which must simply run its course while symptoms are managed, the Fed's tools are often unable to address the root causes of economic challenges. In principle, monetary policy is intended to ease difficulties in areas such as employment and inflation. In practice, however, the Fed does not exercise direct control over the economy. It responds to the economic environment rather than dictating it.

The central challenge today is persistent inflation. This is largely attributable to elevated oil prices stemming from the ongoing war in Iran, which has prolonged the closure of the Strait of Hormuz and generated broader regional disruptions. The Fed clearly has no ability to resolve these geopolitical developments through interest rate policy. What it can do is work to prevent inflation from spreading beyond energy prices into other categories that affect consumers and businesses more broadly. Understanding the Fed's role in this context raises an important question for long-term investors: how should they think about their portfolios in light of these developments?

The Fed's latest rate hike came as no surprise to investors



At its September meeting, the Fed chose to raise policy rates by one-quarter of a percent, bringing the target range to 3.75% to 4.00%. This marked the first rate increase in three years, following a series of cuts that took place between September 2024 and December 2025. Because this decision was widely anticipated by investors beforehand, markets experienced some brief volatility immediately following the announcement but ultimately absorbed the move without significant disruption.[2]

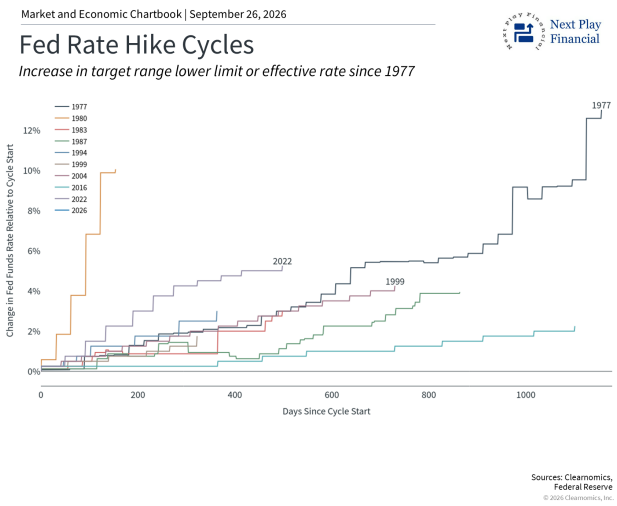
What sets this particular rate hike apart is the nature of the inflation driving it. The Fed is primarily responding to elevated energy prices, with oil still hovering around $100 per barrel. Economists describe this type of inflation as “cost-push inflation,” meaning that supply disruptions have been the catalyst for higher prices. This differs from “demand-pull inflation,” which arises when a rapidly expanding economy generates excessive consumer demand that pushes prices upward.

In 2022, both dynamics were simultaneously at work. Low interest rates and government stimulus fueled demand-side inflation, while supply disruptions tied to the pandemic and Russia’s invasion of Ukraine created supply shocks. Economists and policymakers typically regard supply-side disruptions as temporary in nature, since they tend to resolve over time. Oil prices did indeed decline following those earlier disruptions, until this year’s geopolitical events renewed upward pressure.

Over recent policy cycles, the Fed had favored a steady, well-communicated approach to rate changes. This practice, commonly known as “forward guidance,” was designed to provide markets with clarity about the likely path of interest rates, particularly during periods of economic stress. New Fed Chair Kevin Warsh, however, has moved away from this approach and has declined to submit his own projections to the Fed’s quarterly Summary of Economic Projections.[3]

His preference is for markets to respond to actual economic data rather than to the Fed’s anticipated next step. This partly explains why investors assigned over a 90% probability to this rate hike ahead of the meeting.[4] Whether or not this represents the optimal approach, it means that underlying data on employment, inflation, and growth carry even greater significance for interpreting the economic landscape. While inflation remains higher than many would like, unemployment continues to sit at historically low levels and GDP growth has remained steady.

Rate hikes are a routine feature of the economic cycle



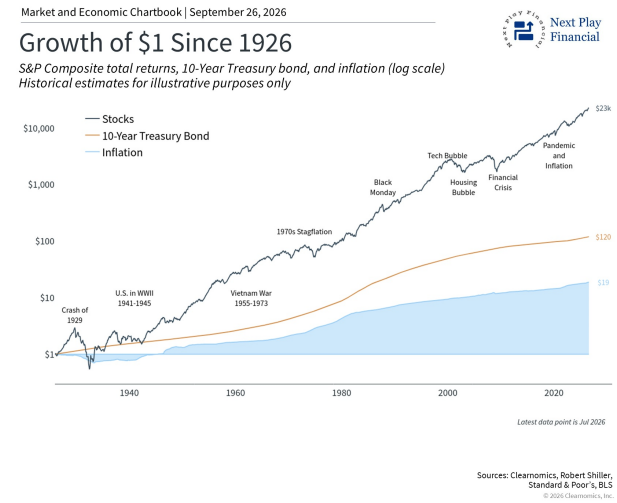
The modest size of the 0.25% hike reflects the current environment. Projections from other Fed officials indicate that the central bank may raise rates once more later this year before pausing through 2027, with only a gradual decline in rates anticipated beyond that point. This represents a shift from the Fed's June forecasts, which had pointed to lower rates. That said, these projections should be interpreted with caution, as they can shift meaningfully from one meeting to the next depending on how economic conditions evolve.

It is understandable that some investors associate higher interest rates with negative outcomes for markets. In reality, the impact depends heavily on the reasons behind the rate increases. It is not unusual at all for markets and interest rates to rise together, particularly during the later stages of a business cycle.

A healthy economy and robust corporate earnings, for example, can simultaneously support rising stock prices and a Fed working to keep inflation contained. Over the past six months, major indices including the S&P 500, the Dow Jones Industrial Average, and the Nasdaq have all moved toward new all-time highs, supported by strong corporate earnings and the buildout of AI data centers, even as interest rates have also risen to multi-decade highs.

There is also a common misconception that the Fed's purpose is to fine-tune the economy with precision. This view was reinforced, in part, by the Fed itself during Alan Greenspan's tenure from the late 1980s to the mid-2000s, when the central bank's decision-making process was relatively opaque. In practice, the Fed more often finds itself reacting to events than steering the economy from a position of control. The chart above illustrates how rate hike cycles have unfolded across a wide range of environments, highlighting the fact that these moves typically play out over extended periods.

Remaining invested is the most effective long-term response to inflation



At the end of the day, investors pay close attention to Fed policy and interest rates because of the implications for their portfolios and financial plans. While the Fed commands considerable attention, its decisions represent only one piece of a much larger picture.

The accompanying chart illustrates how financial markets have supported investors across more than a century, through countless Fed decisions, economic shocks, recessions, geopolitical upheavals, and other events that loomed large in their time. Throughout this span, inflation drove costs higher by 19 times, meaning that what cost $1 in 1926 costs $19 today. Despite this, both stocks and bonds significantly outpaced inflation over the same period. For those who remained invested, this supported portfolios in generating income and building wealth over time.[5]

Of course, markets do not move in straight lines, and investors should always be prepared to navigate uncertainty. This is precisely why maintaining a portfolio that is aligned with long-term financial goals remains far more important than attempting to predict or time the Fed's next move.

The bottom line? The Fed's latest rate hike reflects inflation due to higher oil prices. Investors are best served by focusing on long-term goals and maintaining balanced portfolios rather than reacting to each Fed decision.

References

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Index Descriptions

S&P 500

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The modern design of the S&P 500 stock index was first launched in 1957. Performance prior to 1957 incorporates the performance of the predecessor index, the S&P 90.

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