

Daily: The case for investing amid rising rates

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Thought of the day

Market sentiment recovered on Thursday as oil prices fell for a second day. The 10-year Treasury yield fell 6 basis points to 4.94%, while the S&P 500 advanced 1.1%. The equity benchmark now stands at just 2% below the all-time high it reached in August.

Brent crude oil remains above USD 100 per barrel, and the war in the Middle East is in its seventh month. With equities near all-time highs and concerns over the sustainability of AI-related investment persisting, a fresh round of central bank tightening and higher interest rates could lead investors to question the case for staying invested. After all, cash feels safe, and market volatility can be unsettling.

But while waiting for certainty may feel comfortable, doing so could pose the greater risk to long-term financial goals.

Cash may not meet long-term return needs. By definition, a portfolio needs to earn a return equal to inflation to maintain its purchasing power. If it must also fund withdrawals, taxes, or a longer-than-expected lifetime, a meaningful positive real return is likely required. In our view, cash is unlikely to meet that hurdle over the long term. Even today's high cash yields are partly offset by inflation and, in many jurisdictions, taxation. We also do not expect the current unusually high real cash rates to persist indefinitely. We estimate the long-run pretax real return on cash at just 0.7%. To overcome the combined challenge of inflation, taxes, longevity, and withdrawals, investors need a higher long-term return than cash is likely to provide.

Higher rates need not end the equity rally. With the global economy on a solid footing, we think modest further central bank tightening should remain manageable for equity markets. Historically, rate hikes become a greater concern for market performance when economic growth starts to falter. But the relatively limited tightening we expect ahead should not impact economic growth much. We also believe AI-related capex remains a powerful tailwind for earnings growth, with the benefits broadening across sectors and geographies. In addition, improving earnings means that elevated valuations can become more reasonable over time. For example, despite the strong performance in semiconductors this year, the sector's valuations are now below their average since ChatGPT's launch in late 2022. Meanwhile, we note that an "all-time high" is neither rare nor a reliable warning signal historically—over the last 100 years, the S&P 500 has traded either at or within 10% of an all-time high for more than two-thirds of the time.

Geopolitical risks rarely alter the long-term case for investing. With no immediate resolution in sight, the current conflict in the Middle East could still escalate, and the energy supply crunch could worsen. But investors should also remember that geopolitical situations can change quickly—as we have seen many times this year. A ceasefire, a reopening of disrupted energy flows, increased production elsewhere, or a diplomatic agreement could all ease pressure on oil markets much faster than is currently assumed. History suggests that geopolitical shocks are rarely a sufficient reason to stop investing. For diversified portfolios, the long-term cost of remaining uninvested has often proved greater than the temporary cost of living through a geopolitical drawdown.

So, given the imperative to invest and our view that the balance of evidence favors staying invested, we recommend retaining enough liquidity for near-term needs while putting excess cash to work. Investors should position for further equity gains through a diversified core allocation and targeted exposure to transformational innovation opportunities, in our view. We also rate fixed income as Attractive, with opportunities across regions and market segments, and think broad commodity exposure can strengthen portfolio resilience.

For more on these themes please read our House View Monthly published on 17 September "War, Warsh, and what to do now."

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