WILSONS

What a Fed Rate Hike Cycle Means For Investors

Our weekly view on asset allocation.

21 March 2022

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

Examining the History of Fed Rate Hikes for clues

In line with market expectations, the US Federal Reserve (the Fed) raised its official Fed Funds (cash) rate by 25 basis points last Wednesday.

The "dot plot" of Federal Open Market Committee (FOMC) members' interest rate projections were also revised sharply higher. The median projection now expects the Fed Funds rate to increase to 1.9% by the end of this year, up from a 0.9% projection at the December 21 meeting. So, compared to just 3 months ago, the Fed has changed its policy guidance from 3 rate hikes in 2022 to 7 hikes. This implies a hike at each of the remaining 6 meetings this year. While this is a significant shift, it was largely in line with market expectations, with pricing sitting between 6 and 7 rate hikes in the run up to the meeting.

The Fed's near-term GDP growth expectations were revised lower, though the unemployment forecast was unchanged, while the Fed's inflation forecast was raised significantly.

Fed Chairman Jerome Powell cited the Ukraine invasion as a source of added uncertainty that could increase inflationary pressures and dampen economic growth.

The initial reaction of financial markets to the Fed communication suggests that the Fed's revised guidance was a somewhat "hawkish surprise". The 10-year Treasury yield rose and the S&P 500 turned negative in early trading. However, these moves were reversed as the day unfolded and equities ultimately ended the day solidly higher. We attribute this market pivot to the post-announcement press conference where Powell emphasised the strength of the US economy and his confidence it can take rate hikes in its stride. Powell also reminded investors that the Fed was prepared to be flexible, emphasising the "data dependence" of the path of the hiking cycle. These comments appeared to significantly soothe market nerves.

So, with a US hiking cycle now finally underway, how are asset markets likely to perform over the medium-term? While history never exactly repeats, it often rhymes, so we have examined the history of Fed hiking cycles for some clues.

Does the History of Hiking Cycles Give us an Investment Roadmap?

Looking at the history of the past 50 years or so suggests a number of tendencies worth noting (exhibit 1).

The length of Fed tightening cycles has varied significantly, ranging from less than a year to more than 3 years. More often than not they are multi-year events, as we believe this current hiking cycle will be.

Fed tightening cycles do not inevitably lead to a recession, but more often than not they do. Of the 10 hiking cycles we have identified since 1970, we have seen 6 recessions (and 7 equity bear markets) flowing off the back of Fed hiking campaigns.

The gap from the first hike to recession is typically fairly long, with an average gap of just over 3 years. The shortest gap between the first hike and the onset of a recession was just 12 months in the (short and sharp) 1980 hiking cycle as the Fed attempted to break the back of inflation.

Exhibit 1: Fed hiking cycles, recessions and asset market performance

Hiking Cycle Start Date	Length Months	Cash Rate at Start	Cash Rate at peak	Months to Next Recession	Months to US 10 year yield peak	12 month % S&P500 price return	Months to S&P500 Peak
Mar-72	26	4.0	11.0	20	30	4	10
Aug-77	32	4.8	16.5	29	32	6.7	30
Oct-80	8	11.0	19.0	9	12	-4	9
May-83	16	8.8	11.5	86	14	-7	53
Dec-86	9	5.9	7.3	43	11	36	9
Mar-88	11	6.5	9.8	28	13	14	18
Feb-94	12	3.0	6.0	85	10	4	77
Jun-99	11	4.8	6.5	25	8	6	13
Jun-04	24	1.0	5.3	42	24	4	40
Dec-15	36	0.3	2.5	50	35	10	50
Average	**19**	**5.0**	**9.5**	**42**	**19**	**7**	**31**

Source: Refinitiv, Wilsons.

As we discussed last week, US recessions almost always follow the inversion of the US yield curve, which typically occurs more than a year after the start of a tightening cycle. The US yield curve has flattened significantly this year but has not inverted. This suggests that recession risks have edged up (off a very low base) but are not particularly elevated. This is consistent with the view expressed by Chairman Powell at last Wednesday's press conference. As we noted last week, US recessions typically occur about 16 months after yield curve inversion.

Read The Flattening US Yield Curve – Are Recession Risks Rising?

It is interesting that this current tightening cycle is commencing with the highest rate of inflation since the 1980 rate hike cycle and the equal lowest starting interest rate. The 1980 hike cycle was also the cycle that had the shortest gap to recession.

Encouragingly for equity investors, 12 month returns following the first hike are "quite respectable" with an above average US market price return of ~7%.

Equities Typically Continue to do OK

12-month equity returns have been positive in 8 out of 10 cycles, so it is typically not necessary to move to a cautious/bearish stance on US stocks due to the onset of policy tightening. The time to equity peak has, on average, been 31 months after the first rate hike.

What About the Reaction of the Bond Market?

Long-term bond yields have been moving up for well over 12 months in anticipation of higher US policy rates. There is currently considerable debate on just how much upside there is in long-term interest rates.

Historically, long-term bond yields peak 19 months after the start of Fed tightening (exhibit 1). This could have implications not just for fixed interest positioning but also equity rotation as the growth style has been under pressure in recent months from rising 10-year bond yields. A continued rise in long-term bond yields could prolong headwinds for the growth style.

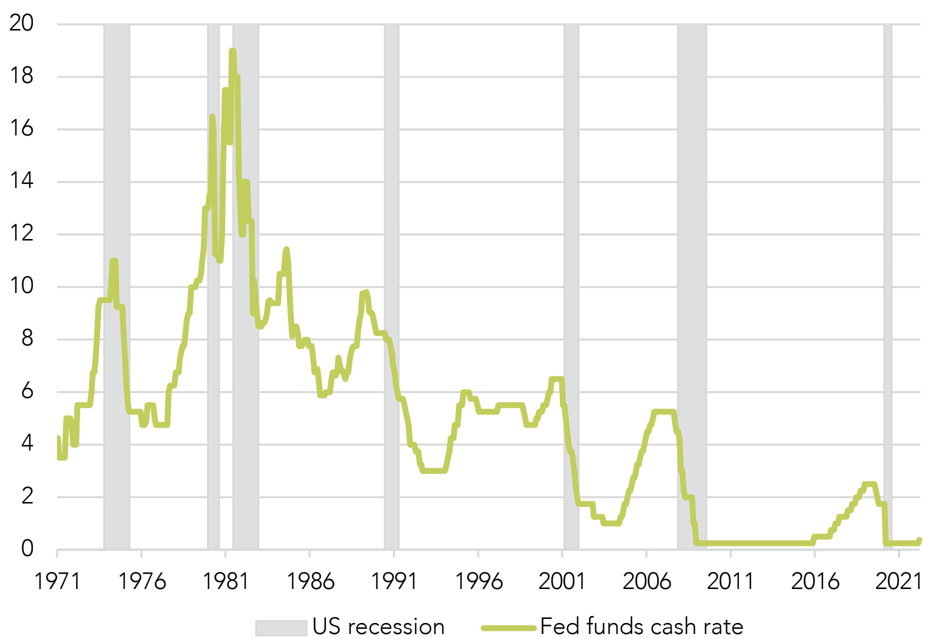
As discussed, short rates move up more quickly in the initial phases of Fed tightening, so it is normal for the yield curve to flatten, as it has been doing recently. The curve typically does not invert for more than a year after the first hike and it has not inverted in every cycle, having inverted in 6 out of 10 hiking cycles.

Staying Constructive on the Outlook for Stocks

So, with the much-anticipated policy tightening cycle now underway, our key message is not to panic about rising US cash rates. Equities have a history of doing reasonably well for some time after the Fed begins lifting rates. A recession may be coming down the track on a 2 to 3-year view, but history suggests it is not a certainty, and it is quite unlikely on a 12-month view.

Of course, these historical tendencies exhibit a fair degree of variance. Ultimately, the path of inflation will be crucial to the pace and length of the Fed hiking cycle. We expect inflation will moderate progressively over the coming year. This should allow the Fed to proceed at a measured and tolerable pace from the perspective of both the real economy and the stock market. However, inflation is unusually high, and we concede its path is still open to debate. We will continue to monitor for signs that our constructive strategic view is under threat.

Exhibit 2: With US cash rates just lifting off zero recession talk seems premature



Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au