ACG Atlanta Consulting Group

ACG Insights: Implications of Higher Rates

Executive Summary

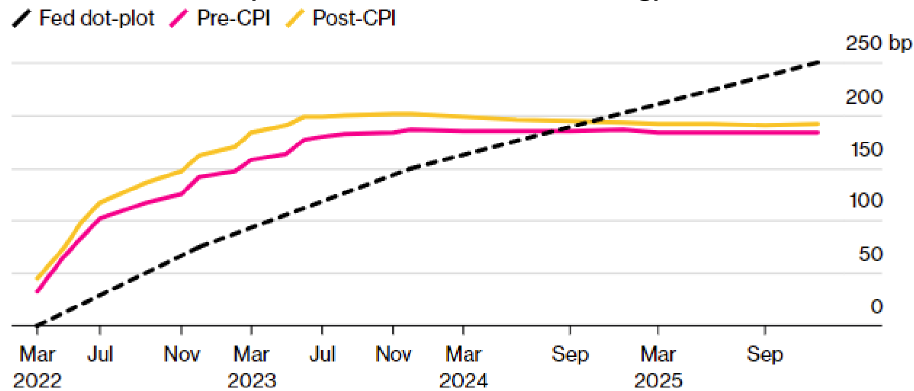
- **Interest rates have trended lower for several decades, however recent events have spurred a shift towards a more hawkish Federal Reserve, and possibly a rising rate environment**
- **Currently faced with the historically tricky position of curbing inflationary pressures while simultaneously avoiding economic recession, the Federal Reserve will be watched closely by market participants over the coming weeks and months**
- **The effects rising interest rates could have on asset prices will be a top-of-mind question for investors going forward as markets grapple with a shifting monetary policy regime**

Introduction

Beginning in the early 1980s, when the Federal Funds rate in the United States hit a historical high of 20%, interest rates have trended towards secular decline. A generally high demand for U.S. debt, actions taken by the Federal Reserve, in conjunction with other factors have pushed interest rates into the historically low-rate environment we have experienced in recent years. In fact, during the onset of the COVID-19 pandemic, the Federal Funds target rate was slashed to effectively zero, placing real interest rates firmly in negative territory in the United States. Real rates, as opposed to nominal rates, are after the effects of inflation.

Although interest rates have been relatively low for an extended period of time now, cracks have begun to emerge in the "lower for longer" interest rate environment. Following several recent inflationary surprises and generally strengthening economic data, the Federal Reserve has announced it expects to end asset purchases (Quantitative Easing or "QE") by March 2022. This clear shift in policy has opened the door for future rate hikes, though the pace and magnitude of hikes is a vigorously debated issue. Exhibit 1 shows current market pricing reflects a Federal Funds target rate of 200 basis points by the end of 2023, however some market participants expect a more rapid pace of rate hikes ahead. In addition, note that following the recently announced 7.5% year over year jump in consumer prices, market pricing adjusted slightly upward (also shown in Exhibit 1).

Exhibit 1: Federal Funds Target Rate Forecast (Fed Dot-Plot vs. Market Pricing)[1]

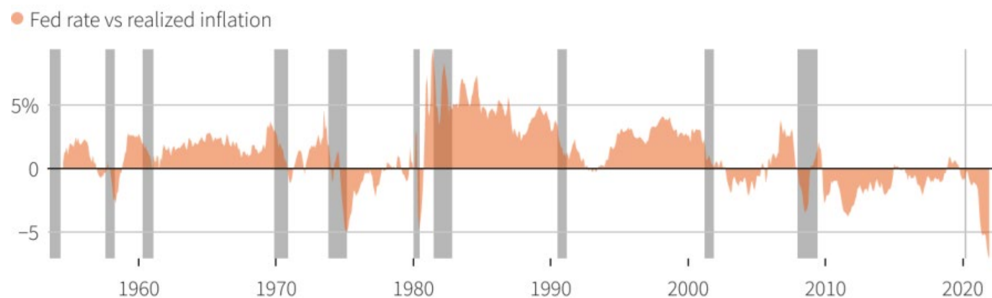


A Balancing Act

To further preface the current market environment, it may be useful to provide some background on the United States Federal Reserve or "central bank". In a modern society, the overarching objective of a central bank is to promote the public good by means of monetary policy that fosters economic prosperity and social welfare. In the United States, as well as in most other countries around the world, the central bank operates under a more specific set of guidelines established by the government. This specific set of guidelines is commonly referred to as the "dual mandate", which describes the Federal Reserve's goal of promoting both maximum employment, and stable prices.

Today, the central bank is challenged to perform the balancing act of maintaining the aforementioned dual mandate. As inflation currently runs well above the Federal Reserve's 2% long term target, the Federal Reserve has announced it will end asset purchases and is expected to raise rates at a quicker pace than previously anticipated. Although consensus among both elected officials and the Federal Reserve has settled on the need to curb inflation, the balancing act will be in withdrawing market liquidity and monetary support, while avoiding economic recession. The early 1980s under chairman Paul Volker provides an interesting case study in the potential effects of lifting rates too rapidly, as overly hawkish monetary policy was possibly the culprit for two subsequent recessions during the decade. Importantly, today's circumstances differ from the 1980s. Exhibit 2 illustrates the Fed has never let inflation run hot for this long without policy action in the past, which may underscore the high likelihood for higher rates in the near future.

Exhibit 2: Federal Funds Rate vs. Realized Inflation[2]



[1] Source: Bloomberg, CME
[2] Source: U.S. Federal Reserve, Bureau of Labor Statistics
Note: Data is gap between federal funds rate and Consumer Price index; Gray bars are recessions

Implications for Fixed Income Investors

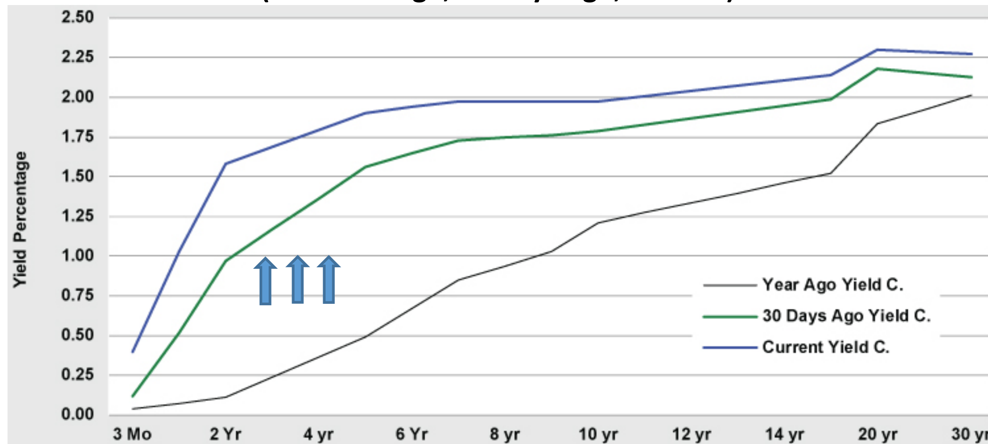
Having considered the potential for a rising interest rate environment, a natural question for investors will be how might this affect asset prices broadly? Within fixed income, the inverse relationship between bond prices and interest rates is fairly simple to understand. As interest rates rise bond prices fall, and vice versa. To elaborate, if an investor owns a bond that is yielding 1% and interest rates rise(fall), the market will assign a lower(higher) value to this bond. A helpful and commonly used term for this relationship is duration. Duration is measured in years and is used to describe a bond's sensitivity to changes in interest rates. For example, if a bond has a duration of three years, and interest rates rise(fall) by 1%, the price of the bond will fall(rise) 3%. See Exhibit 3 below for an illustration of how duration effects bond prices. To place this discussion in the context of today's market, when entering a rising rate environment, fixed income instruments with longer durations will likely see lower returns as compared to less interest rate sensitive securities. Note that the below chart is a hypothetical illustration, and assumes a parallel shift in the yield curve, meaning rates across all maturities increase 1% evenly. This relationship is more complex in practice.

Exhibit 3: % Change in bond prices if rates increase 1%[3]

As we establish the clear relationship between bond prices and interest rates, it is important to remember that the Federal Reserve's direct influence lies in the short- or near-term end of the yield curve, and duration is just a single factor that could affect bond prices. To further explain, if investors perceive hikes in short term interest rates as overly aggressive and potentially harmful to future economic growth (meaning rates are likely to fall in the future to help stimulate growth again), then investors are likely to buy bonds with longer durations (more sensitive to interest rates). The effect this typically has is a "flattening" or "inversion" to the shape of the yield curve. For example, in Exhibit 4, we can see that over the last 12 months, as the Federal Reserve has ramped up its hawkish rhetoric, interest rates on the short end of the yield curve have increased drastically, as investors anticipate a higher future Federal Funds rate. This has resulted in a flatter yield curve. An important observation to make here is that while it is clear rates at the short end of the curve have already increased in anticipation of future Fed Funds rate hikes and will continue to do so as the Fed raises rates in the future, what remains less clear is the extent to which intermediate and long-term interest rates rise. As displayed in Exhibit 4, long term rates appear more anchored.

[3] Source: Blackrock

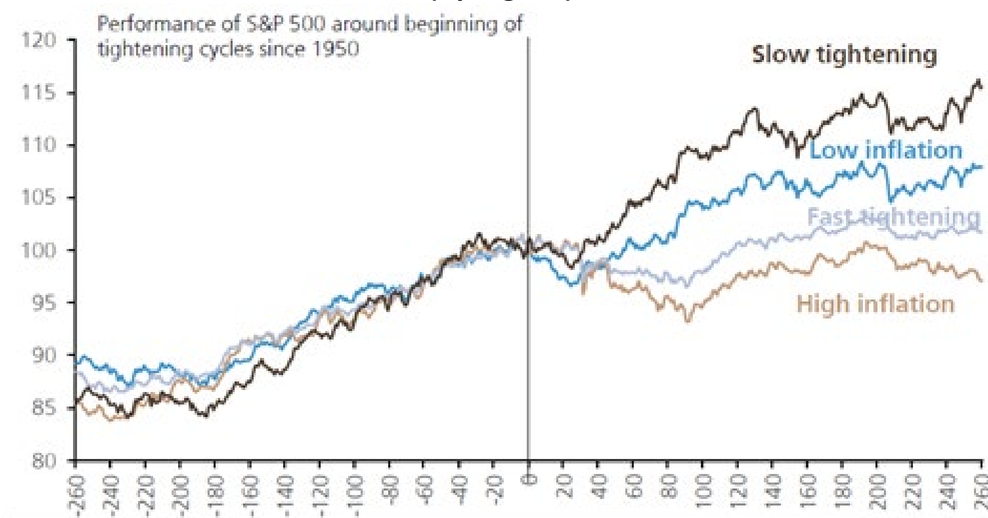
Exhibit 4: % Historical Treasury Yield Curve (One Year Ago, 30 Days Ago, Current)[4]



Implications for Equity Investors

Now that we have a basic understanding of fixed income as it relates to shifting interest rates, the next logical direction would be a discussion of equities. When considering this relationship, it may be useful to break our observations into short term and longer-term relationships. In the short term, data tells us that performance for equities can be quite mixed depending on the environment. To illustrate this, Exhibit 5 shows the performance of the S&P 500 in the days leading up to and just after the start of hiking cycles since 1950 (number of days represented by x-axis). We can see that the range of outcomes is fairly wide once a tightening cycle has begun.

Exhibit 5: S&P 500 around start of hiking cycle (by regime)[5]

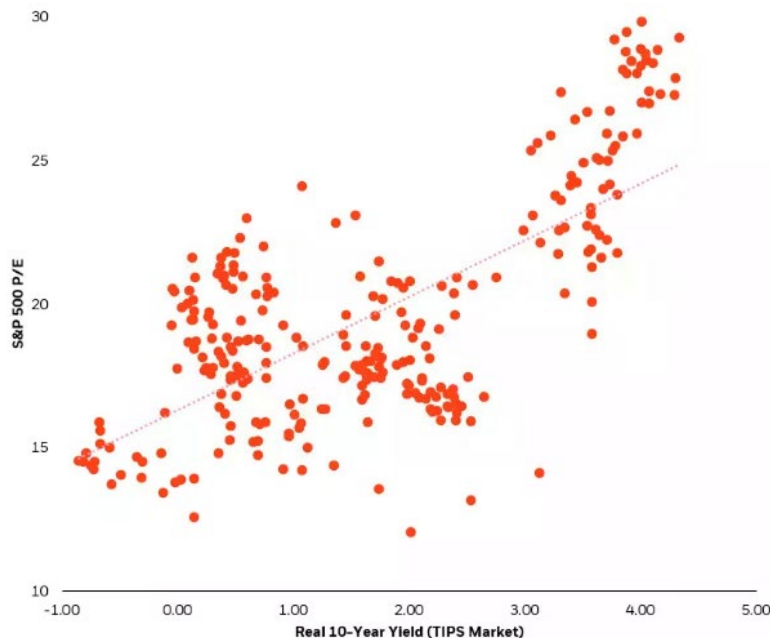


Though Exhibit 5 above may be alarming at first glance, when making decisions regarding asset allocation, it is generally better to think in terms of years and decades, rather than days and months. Over longer periods of time,

[4] Source: Alloya Corporate Credit Union, data as of 02/15/22
[5] Source: Bloomberg, FactSet, UBS

equities have actually provided a good hedge against rising rate environments. The '70s and early '80s have often been cited as evidence that higher rates coincide with lower valuation and poor returns. This relationship, however, appears to change when interest rates increase from a low-rate environment. Exhibit 6 below shows that there has been a strong positive correlation between equity valuations and real yields since the inception of the Treasury Inflation-Protected Securities (TIPS) market in 1997.

Exhibit 6: U.S. Real 10-Year Yields and Equity Valuations (1997-2020)[6]



The chart above does however deserve the disclaimer that all sectors and styles do not react equally within the index as interest rates rise. For example, growth stocks, which project positive cash flows further out in the future, tend to lag value stocks during periods of rising rates. Additionally, certain sectors, like financials and industrials, tend to outperform during periods of rising rates. These sectors tend to contain companies that inherently have the ability to pass on inflation and benefit from an improving economy. Shifting sector and style dynamics like these may present the opportunity for active management to be selective and add value over time.

Conclusion

In recognizing that we may be faced with higher rates in the near future, undoubtedly, many investors will be tempted to make large tactical shifts to portfolios or attempt to time the market around rate moves. Though indications may seem clear currently, it is important to also recognize that a wide range of outcomes are still possible. Our view is that portfolios should always be constructed in a well-diversified manner, and that gradual opportunistic shifts may be appropriate in certain circumstances. Our focus remains on long term outcomes, risk management, and achieving the specific goals of each of our clients.

[6] Source: Bloomberg, Blackrock

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