A Return to Normality: An Analysis of the Impact of Fed Tightening

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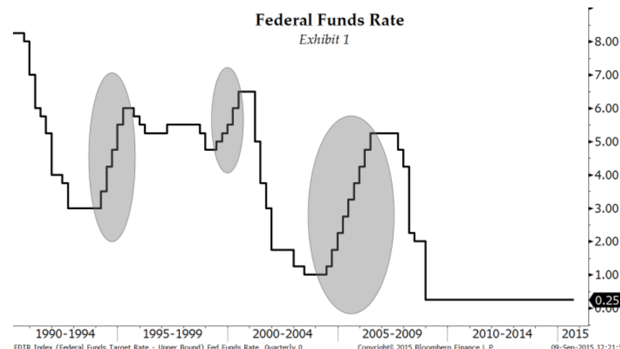
Overview

In 2008 the U.S. economy was in dire condition, leading the Federal Reserve to implement unprecedented accommodative monetary policy. In an attempt to stimulate economic growth, the Fed cut the benchmark federal funds rate to 0.25% and launched a massive stimulus program known as quantitative easing (QE). Now, following more than six years of slow economic recovery (the unemployment rate has improved from 10.0% to its current level of 5.1%), the economy is in much better shape. As a result, the Fed is beginning the process of "tightening" monetary policy back to more normalized levels. While this move is likely warranted by the improvement in economic conditions, it still incites anxiety and concern in many investors. This paper will address both the economic and financial markets impact that Fed tightening is expected to have.

The How, Not the When

Speculation about when the Fed will move to raise rates is currently a hot topic in the world of finance. It seems that opinions are plentiful on when the process of normalization will begin. Many investors believe the first rate increase will be announced at the September Fed meeting later this month, others believe it will be in December, or even early 2016. Despite these minor variations, overall there is near unanimity that the Fed will begin to raise rates within the next few months - barring a significant change in economic conditions.



While ***when*** the Fed will begin raising rates has dominated recent headlines, we believe that ***how*** the Fed raises rates will prove to be even more important. Historically, the Fed has raised rates in a systematic and continuous manner (see the shaded areas in *Exhibit 1*), but this time around we expect the increases to be far slower and less orderly. The Fed has echoed this sentiment, repeatedly stressing that the path of interest rates will be "data-dependent"[1], meaning that they will have the option to accelerate, halt or even reverse rate increases based on economic developments. This flexibility should keep the Fed from tightening too quickly, which could stifle economic growth. We also believe that the peak level of interest rates in this cycle will be much lower than in previous cycles, due to sluggish global growth and a lack of inflation.

We believe these two factors: 1) the slow path of rate increases and 2) the lower peak level of interest rates, should help make the return to a more normalized environment a bit smoother.

[1]http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20150617.pdf

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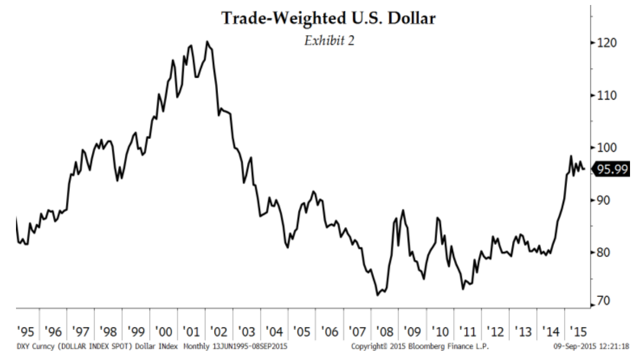
Monetary Policy and the Economy

While the Fed has maintained the stance that economic data will determine the path of rate increases, they must also be aware of the reverse - the potential negative impact that their policy moves may have on the economy.

One area of particularly strong Fed impact is in the realm of currencies. While in the long-run, currency valuations are generally predicated on growth levels and other economic factors, in the short-term, monetary policy can have a substantial influence. This is exactly what we have seen in the U.S. over the last year, as the value of the dollar has increased by 20% in anticipation of Fed tightening (shown in *Exhibit 2*). This rise in the dollar has already begun to have a serious impact on our economy, the most notable of which is the effect it has had on net exports. The stronger dollar makes goods produced in the U.S. more expensive and goods produced overseas cheaper, which has led to a surge in imports and a drop in exports. If the dollar continues its rise, net exports will likely provide a headwind to U.S. GDP numbers.

Corporate earnings have also felt an impact from the strengthening dollar. Over 40% of S&P 500 sales come from overseas, and during periods of strong U.S. currency appreciation these overseas earnings are worth much less once converted back to dollars. This has already proven to be a significant headwind for multinational U.S. companies.

In sum, if the dollar continues to strengthen, it will likely widen our trade deficit, and even threaten to slow corporate earnings growth.



Another area that will be influenced by rising interest rates is the housing market. If interest rates pick up it could put a damper on real estate demand, as higher rates make buying a new home less affordable. While this will provide a slight headwind, we believe that the underlying economic conditions of: 1) robust employment numbers, 2) stronger household formation, and 3) low housing inventory, will allow the housing market to sustain strength despite a pickup in interest rates. Furthermore, higher interest rates should spur banks to become slightly more lenient in their mortgage lending, which has become quite selective amid lower rates. So, while higher rates may make mortgages slightly more expensive, we believe that rising rates are not enough to derail the progress in the housing market.

Finally, discretionary income stands to rise, after years of being squeezed by low interest rates. On the whole, consumers have more interest-bearing assets than liabilities [2]. Therefore, when rates rise their interest income will increase more than interest expense, which could provide a nice boost to spending.

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[2] Source: Federal Reserve: https://www.richmondfed.org/~/media/richmondfedorg/publications/research/region_focus/2012/q2-3/pdf/federal_reserve.pdf

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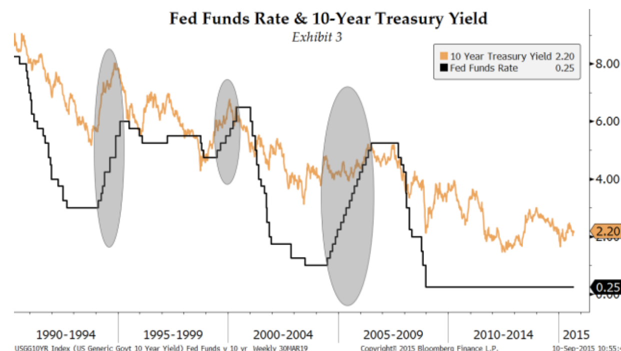
In all, aside from the potential negative impacts from currency fluctuations, the economy appears resilient enough to withstand the Fed's commencement on the path towards normalization.

Rising Interest Rates and the Bond Market

Let's now take a look at how financial markets stand to be impacted.

In theory, fixed income investments should suffer during periods of rising interest rates, as bond prices move inversely with rates. While there are certainly risks associated with fixed income during periods of rising rates, historically, bonds have actually held up relatively well during Fed tightening, despite bouts of short-term volatility. Taking a look back at previous periods of rising interest rates, in *Exhibit 3*, you can see that historically, when short-term rates rise, longer-term rates increase as well, but to a lesser extent. Let's take a deeper dive into how bonds performed during these periods.[3]

On February 4, 1994 the Fed, led by Allen Greenspan, began raising the fed funds rate, after being anchored at a multi-decade low of 3.0% for more than two years. Upon the announcement, bonds sold off sharply and continued to suffer as rate increases continued. By May, the bond market was down over 6.0%, as investors rushed to sell their bonds. With expectations that further losses were on the way, the selloff finally subsided late in the year when rates began to come back down. By early



1995, almost all of the losses in bonds had been recouped, and bonds ended up losing only 1.3% over the duration of the Fed's rate increases.

Next, in 1999, the Fed increased the fed funds rate from 4.75% to 6.5%. Once again, there was some volatility when rates first began rising, but over the duration of the cycle bonds actually ***gained*** 2.7%.

Finally, during the last period of Fed tightening, from 2004 to 2006, the fed funds rate increased from 1.0% to 5.25%. During this time, longer-term rates remained relatively flat (see gold line in *Exhibit 3*) and bonds ***gained*** 6.8%.

While every interest rate cycle is different, recent history shows that rising interest rates do not have to be a catastrophic event for fixed income investors. Obviously the 1994 rate cycle may incite some concern among investors due to the steep losses that were incurred in the first few months of rate increases. However, if investors were patient and did not panic amid the losses, they would have recouped almost all of their losses within a year. While 1994 is often cited today as a possible scenario for bonds when the Fed beings to tighten, we would highlight three key differences between

[3] Bond returns based on Barclay's Aggregate Bond Market Index, returns provided by Bloomberg Terminal.

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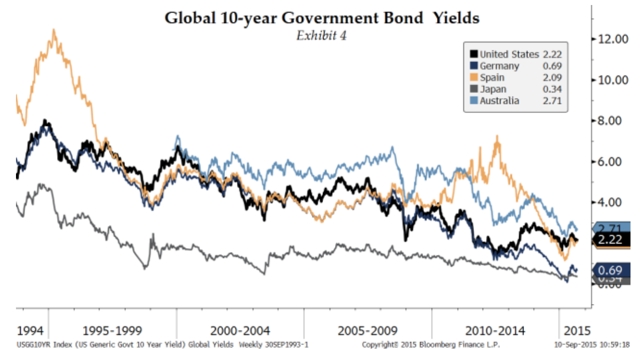
today's market and 1994, two of which potentially lessen the losses we may see in fixed income, and one which leaves our current situation more vulnerable.

1) The Fed is much more transparent today than they were in 1994. When Greenspan announced the initial rate increase in 1994, he clearly shocked the market, which contributed to volatility. Today's Fed is focused on communicating clearly with the market, and we believe this should alleviate some of the volatility that will be experienced when rates begin to rise.

2) Global growth and inflation are much lower today than they were in 1994, which should keep interest rates from rising too rapidly. While growth in the U.S. has been relatively strong, setting the stage for tighter monetary policy, the rest of the world is dealing with slower growth and near zero inflation. Around the globe, central banks are cutting interest rates and initiating QE programs in an attempt to stave off deflation and stimulate growth. All of this loose monetary policy has driven interest rates around the world to unprecedented low levels. Looking at *Exhibit 4*, you can see the downward trend of global interest rates in recent years. We find it hard to believe that U.S. interest rates will move significantly higher when global yields are so low.

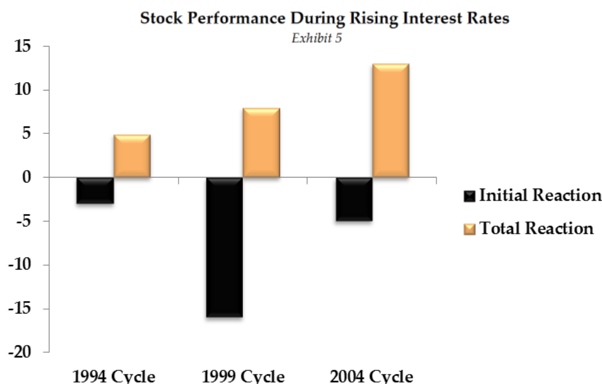
3) The income investors are receiving from bonds in today's environment is much lower than in 1994, which leaves investors more sensitive to a drop in bond prices. Consider this example. Bond returns are a function of two factors: 1) Price- which is influenced by interest rates, and 2) Income- which is stable over the term of a bond, barring a default. If bonds lose 10% in price, but receive 7% in income, the loss is only 3%, which is pretty manageable. However, in today's environment where a lot of bond funds yield less than 3%, a loss of 10% in price would leave an investor with a loss of 7%, which is much tougher to stomach. For this reason, if rates were to accelerate rapidly, the *potential* for losses is much higher than it was in 1994. However, due to the two factors mentioned above, we do not see a sustained significant jump in interest rates as a likely scenario.



The bottom line for fixed income investors is to stay disciplined in their investment strategies. While bonds will likely face short-term volatility, it is important to remember two of the key roles that fixed income plays in a diversified portfolio: to provide income and ***downside protection*** during a stock market selloff. If these two factors are considered, short-term fluctuations in value end up being much easier to handle.

Rising Interest Rates and U.S. Equities

While fixed income markets face headwinds during periods of Fed tightening, rising rates are generally associated with an improving economic landscape, which bodes well for



stock market returns. Looking at *Exhibit 5,* we can see that stock returns[4] have been positive in each of the three previous periods of rising interest rates, despite strong initial selloffs. We expect to see similar levels of volatility when the Fed begins raising rates this time around, but do not think rising rates alone are enough to trigger a bear market.

While stocks have generally performed quite well during periods of rising interest rates, it is important for investors to understand that any rate increases would occur on the heels of one of the longest bull markets in history. Even after the stock market pullback in August, the S&P 500 is up more than 90% over the past five years. As a result of this rally, stock market valuations are no longer cheap and investors must be more selective in their equity investments than they have been over the past few years.

[4] Measured by S&P 500 returns. Initial reaction is measured between the day of first rate hike and next meeting. Total reaction is measured by total return over the course of the tightening cycle.

A Key Area to Watch - Emerging Markets

Impacts from changes in Fed policy are not limited to our borders. One area that we would caution investors to watch is emerging markets. Since the financial crisis, money flows into emerging market equity and debt have been massive, as investors sought out higher yields and stronger growth potential. With yields set to rise in the U.S. at the same time that emerging market economies are reeling from the economic slowdown in China and the fall in commodity prices, emerging markets are now susceptible to large monetary outflows. We believe that over the short-term, emerging markets will experience significant volatility from these factors. For this reason, we caution investors who do not have a long investment horizon, or who are not comfortable with bouts of volatility, to take a close look at their emerging market allocation.

Conclusion

With the Fed set to begin its journey toward a more normalized monetary policy environment, many investors are anxious about the various impacts that this will have. Overall, we believe the economy is strong enough to handle a return to more normalized levels, although the risks of a further appreciating U.S. dollar are not insignificant.

As for financial markets, many investors view a shift towards tighter monetary policy as a near apocalyptic event (as evidenced by the selloffs we see each time the Fed announces they are closer to tightening, namely the "Taper Tantrum" in 2013), but in reality fixed income markets have held up quite well and

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equity markets have thrived during previous periods of rising interest rates. In short, we expect volatility to increase in the early stages of Fed tightening, but advise investors to stay disciplined in their investment approach, and to not let volatility affect their long-term goals.

In our July 2015 letter to clients we wrote about the important differences between short-term volatility and long-term permanent losses - it might now be a good time to re-read that letter (at www.AllegiantPA.com).

Regards,

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