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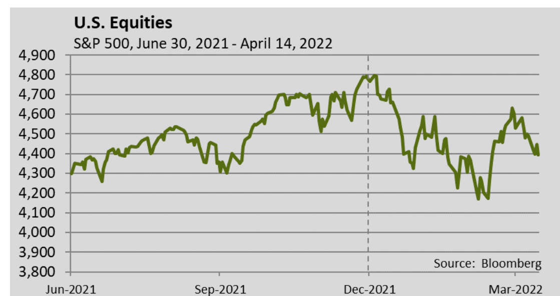
Don't Fight the Fed

April 2022

Summary

The Federal Reserve has a big challenge: Tame a surge in inflation that reached levels not seen in four decades without pushing the economy into recession. At the same time, disruption from the pandemic and war in Ukraine increases the uncertainty and complexity of the situation. The Fed has limited tools for this environment. They don't control global supply chains, nor do they control Covid cases or Putin's aggression, so they intend to slow demand for goods and services by using the only tool at their disposal: higher interest rates. There is a strong correlation between Fed policy and the direction of the stock market. A simple but useful mantra is, "Don't Fight the Fed."



As expected, volatility in the S&P 500 increased substantially year-to-date. While the biggest decline in 2021 was -5.1%, stocks have seen three swings where stocks fell by more than -7.0% already this year, resulting in an overall -13% decline from January 1 to mid-March. The stock market has been somewhat resilient so far, all things considered, but there are many factors that may lead to continued swings in financial markets:

- The economy is still quite strong with a record 1.7 posted job openings for each person who is looking for work.
- Consumer sentiment, perhaps driven by inflation and increasing home prices, is not consistent with a strong economy, reflecting the worst outlook since the European Debt Crisis in 2011.
- Interest rates have risen dramatically; a home buyer will pay 32% more for a 30-year mortgage than they did in 2021 as mortgage rates moved from 2.8% to 5.1% over nine months.
- The Fed initiated a plan to tighten monetary policy significantly. While only one rate hike has been implemented so far, six more are planned by the end of the year.
- Stock market volatility is normal. Since 1980, the average intra-year drawdown is -14%, but the stock market still delivered positive returns in 32 of 42 years. In March, the S&P was down -13% from the beginning of the year.
- The first few months of 2022 saw the biggest bond losses in over 40 years. Despite a rough start to the year, the S&P 500 is up +3.3% since last summer. The Bloomberg Aggregate Bond Index lost -8.5% over the same period.
- The second and third quarters of the midterm year are the weakest of the sixteen quarters in the presidential election cycle.

The environment is rather unique with inflation, Fed policy, and bond losses reaching levels not seen in decades. Ned Davis Research summarized the outlook succinctly, "Whatever the scenario to come, it's likely that the market performance will be driven by the sentiment surrounding inflation numbers, expectations for future inflation and the prospects for tightening monetary policy."

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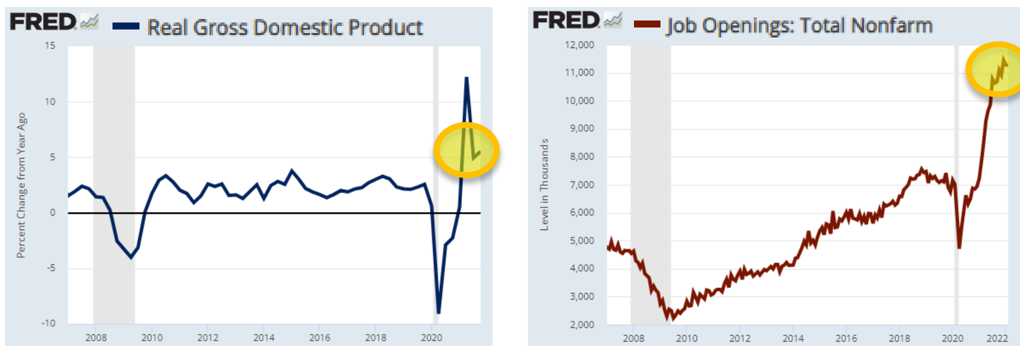
Client portfolios have been adjusted with the following outlook...

While a recession may not be imminent, the outlook for equity markets has weakened substantially. High levels of inflation and aggressive Fed policy to address it may continue to create volatility. Typically, financial markets are somewhat immune to the first few rate hikes from the Fed. However, the Fed has not raised rates this swiftly in 15 years, and such an approach may encounter some resistance. As a result, client portfolios have been moved to their Neutral position, which is halfway between their Maximum and Minimum equity targets.

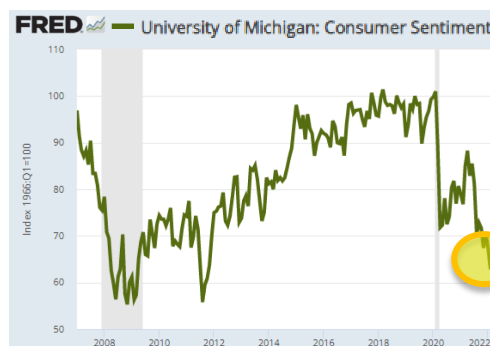
The economy is still strong...

Most data used to gauge the strength of the economy is still very positive. Even after adjusting for inflation, economic growth (Real GDP, below) reached 5.5% in the fourth quarter, a pace that is effectively double that of any rate since the financial crisis in 2008. Job openings (below) are also extremely high compared to recent history. Unemployment fell to 3.6% in March, the second lowest reading since 1969. Also in March, weekly initial jobless claims fell to 166,000, the lowest level since 1968 when the U.S. population and economy were significantly smaller.



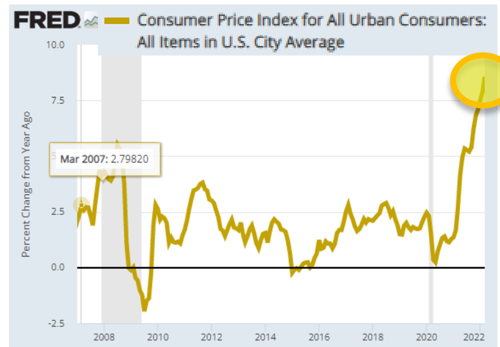
But people feel very negatively about the future...

The University of Michigan Consumer Sentiment index measures consumer attitudes and level of optimism for the future through questions on the business climate, personal finance and spending. In March, the index fell to the lowest level since the financial crisis in 2008 and the European debt crisis in 2011. The index typically hits low levels during a recession and rises as consumers feel like their situation is improving. The current lack of confidence is somewhat perplexing given the strength of the economy.



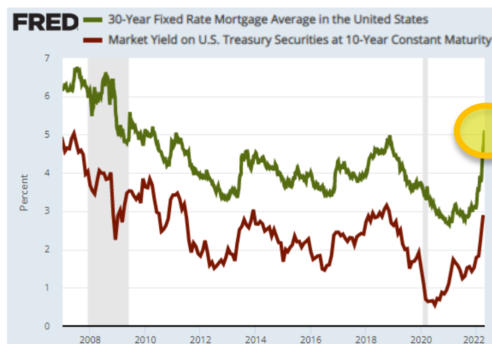
Primarily because inflation is at a four-decade high…

Inflation readings for the past few months have been quite elevated. A combination of Covid-related supply chain constraints, war in Ukraine, a robust economy and accumulated savings from the recent stimulus have pushed inflation to levels not seen in forty years. While many economists thought inflation has been too low for a decade, CPI inflation (below) hit 8.6% in March. Many financial concepts can be vague or complicated, but inflation fears in this environment are reinforced by common items like the cost to fill up your car with gasoline. It previously cost $40 to fill a tank of gas, and now the same tank may cost $80. High fuel prices are not the same as inflation, but they exacerbate concerns driven by news headlines.



And the cost of borrowing money is rising quickly…

There are many different types of loans (mortgages, auto loans, businesses, and government) in addition to many different loan structures (number of years on the loan as well as the whether the rate is fixed or variable). Regardless of loan type or structure, interest rates spiked dramatically this year. It is much more expensive to finance a purchase or transaction than it was just four months ago.



Period	August 2021	April 2022	Difference
Structure	30-year fixed	30-year fixed	
Rate	2.8%	5.1%	
Monthly payment	$1,232	$1,629	$397
Monthly interest	$700	$1,275	$575
Annual interest	$8,317	$15,199	$6,822

The housing market is likely to remain stable because inventory and supply remain low. However, the pressure of higher mortgage rates will be noticeable. For example, the monthly payment on mortgage jumped significantly in the last nine months. A home buyer, purchasing the same house with the same $300k in borrowed principal, would pay 32% more per month for a mortgage at 5.1% versus 2.8% (see table, above right).

Even if mortgage rates were artificially low during the pandemic recovery period, breaching the 5% threshold is meaningful. Many home buyers do not recall rates this high as rates have not exceeded 5% since 2011!

Since the Fed announced an aggressive plan to fight inflation…

Citing strong economic growth, a tight labor market, and surging inflation, the Federal Reserve's approach to monetary policy changed significantly over the past several months. In a March speech, Fed Chairman Jerome Powell noted that the inflation outlook had deteriorated significantly, and the rise in inflation has been much greater and more persistent than expected. As recently as December, the Fed projected three rate hikes for 2022, but the current Fed plan indicates seven rate hikes, which would raise the Fed Funds rate to 1.75% - 2.00% by the end of the year.

The history of tightening monetary policy is somewhat concerning. Each of the last seven recessions (1969, 1973, 1980, 1981, 1990, 2001, and 2007) were preceded by a Fed hiking cycle. Not every hiking cycle has led to a recession, but stock market drawdowns during a recession tend to be much deeper. Perhaps more importantly for the current environment, stock market returns tend to be weaker during hiking cycles; this is one of the factors leading to the phrase "Don't Fight the Fed." Below is data on Fed hiking cycles since 1980. On average, hiking cycles last a little over two years, result in an increase of Fed Funds rate of 2.9% and generate low stock market returns. Notably, the most negative stock market returns occur during the recession which follows the rate hiking cycle, not during the hiking period itself.

Period	Number of hikes	Duration of rate hikes (months)	Change in Fed Funds Rate	Change in 10-year Treasury yield	S&P 500 price return	Trigger a Recession (lag time, months)
May 1983 - July 1984	7	14	3.13%	2.74%	-9.6%	No
March 1988 – February 1989	10	11	3.25%	0.91%	6.8%	Yes (28)
February 1994 – February 1995	7	12	3.00%	1.85%	-2.1%	No
June 1999 – May 2000	6	11	1.75%	0.50%	-8.5%	Yes (21)
June 2004 – June 2006	17	24	4.25%	0.52%	12.0%	Yes (42)
December 2015 – December 2018	9	36	2.00%	0.49%	19.0%	No
Average of past 6 cycles	9	28	2.90%	1.17%	2.9%	3 of 6

Source: BCA Research, JP Morgan

In his March speech, Powell addressed the concern that it is difficult for the Fed to slow inflation without triggering a recession,

> *"Some have argued that history stacks the odds against achieving a soft landing, and point to the 1994 episode as the only successful soft landing in the postwar period. I believe that the historical record provides some grounds for optimism: Soft, or at least soft-ish, landings have been relatively common in U.S. monetary history. In three episodes—in 1965, 1984, and 1994—the Fed raised the federal funds rate significantly in response to perceived overheating without precipitating a recession. In other cases, recessions chronologically followed the conclusion of a tightening cycle, but the recessions were not apparently due to excessive tightening of monetary policy. For example, the tightening from 2015 to 2019 was followed by the pandemic-induced recession."*

Powell's argument does have some merit, but a deeper analysis is important. Not only is it imperative that the Fed chairman explicitly state the Fed does not plan to create a recession, but there is also important nuance to consider. First, recessions do not typically occur during the hiking period. However, they do tend to occur with a lag of roughly 26 months from the initial hike. Second, the four soft landings cited saw stock market drawdowns of -11%, -13%, -9% and -20% in 1964, 1984, 1994 and 2018, respectively. Third, for the last 15 years, monetary policy has been quite easy. The only meaningful rate hiking cycle since the financial crisis saw nine hikes over three years. The current plan calls for seven in roughly nine months. While the initial phase of a Fed hiking cycle is typically positive for stocks, the Fed's aggressive plan may create volatility in financial markets this year.

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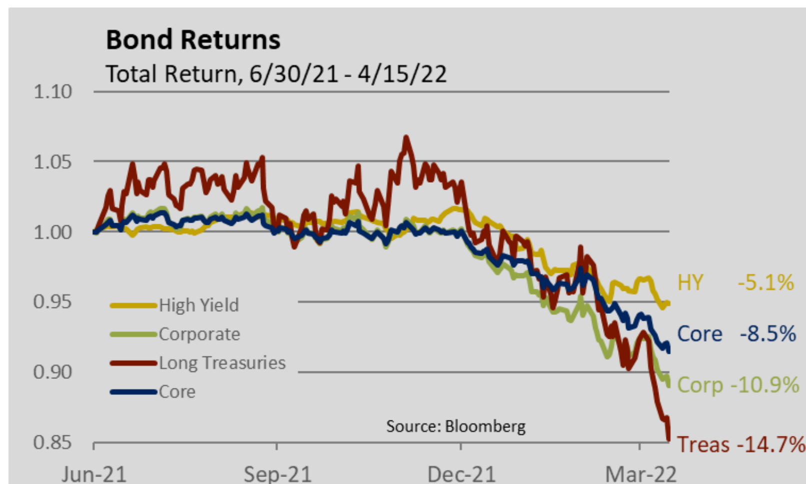
Rising interest rates delivered painful bond returns...

Calendar year 2021 was a tough period for bond investors, but the first few months of 2022 saw the biggest bond losses in over 40 years. Interest rates rose sharply after the Fed initiated a plan to raise rates significantly by the end of the year. Since bond prices move in the opposite direction as interest rates, bond losses were significant (see below refresher on bond dynamics). The Fed only controls short term rates through the Fed Funds rate (which is the rate at which banks lend to one another). While the Fed has only raised the Fed Funds rate once this year (by 0.25%), the rest of the bond market responded swiftly to investor pressures. For example, the yield on the 10-year Treasury bond more than doubled from 1.2% in August 2021 to 2.8% in April 2022, and the average rate on a 30-year fixed mortgage rose from 2.8% to 5.1% over the same period.

Since last summer, the vast majority of bonds saw meaningful losses. High yield (higher risk) bonds lost -5.1%, core bonds (i.e. the Bloomberg Aggregate Bond Index, which is the most widely tracked bond benchmark) lost -8.5%, corporate bonds lost -10.9% and long-term Treasury bonds lost -14.7%. Such a dramatic loss in bond returns is quite uncommon. In fact, inside a 12-month window, bonds have not lost at this pace since 1980, when the Bloomberg Aggregate lost -12.6%.



While most investors pay attention to recent stock market volatility, the bond market has had a tougher run recently. Since last summer, the S&P 500 is up +3.3%, compared to losses in all of the above bond sectors. In addition, one of the biggest concerns to start the year is inflation, so it would be logical that inflation protected securities would be a safe haven. While they performed better than most bonds, TIPS lost -1.1% over the same period.

<u>Bond geek refresher:</u> Why do bond prices and interest rates move in different directions? A simplified example may be helpful. An investor buys a corporate bond that pays 3% per year; later in the year, the same corporation issues a new bond that pays 4%. It is the same company and same risk, but the newer bond pays more. Why would an investor hold the bond paying 3%? They would not. So, the price on the original bond paying 3% must fall to make it attractive to investors.

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Which fits well with expectations of Presidential Election Cycle.

There are many drivers of return in financial markets, and the presidential election cycle fits very well with the dynamic present in 2022. The post-election year period often features strong government stimulus on the heels of optimism from a newly elected president. The midterm year in the four-year presidential cycle is typically characterized by a somewhat robust economy leading to low unemployment and inflationary concerns. Political uncertainty increases while both monetary and fiscal support for the economy slow (since there is less need for monetary stimulus and legislation slows heading into the midterm elections).

	Post Election Year	Mid Term Year	Pre-Election Year	Outgoing Election Year
Percent Up Years	63%	61%	89%	83%
Median Gain Per Year	9.1%	6.2%	18.1%	10.7%
Incumbent Party Wins (gain)	11.6%	8.5%	14.1%	9.7%
Incumbent Party Loses (gain)	4.8%	3.4%	19.4%	4.3%

Source: Ned Davis Research

This general cycle narrative fits 2022 very well. Stimulus and a robust economy, paired with supply chain issues, created the highest inflation in forty years. Monetary policy became much less accommodative, and political uncertainty is increasing with the expectation that the Democrats will lose at least one or both houses of Congress. The tendencies of this period in the four-year cycle are as follows:

- The midterm year is the weakest of the four years in the cycle, and the weakness is more pronounced under first year Democrats.

- In particular, the second and third quarters of the midterm year are the weakest of the sixteen quarters in the cycle.

- While monetary policy tends to tighten in the midterm year, the Fed's current plan for monetary policy is the most significant shift in direction in at least 15 years (maybe even since the 1980s).

- The dynamics of the midterm years often lead to more volatility. Only 6 of the 30 midterm years since 1900 have experienced maximum stock market declines of less than -10%. The median midterm correction is -17% versus -13% for all years.

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Final Thoughts

Since the beginning of the year, both stocks and bonds have seen notable losses. This is a historically rare occurrence. In some ways, this is a unique environment with spiking inflation, aggressive Fed rate hikes, large bond losses, and the destructive war in Ukraine. However, these same conditions could be seen as part of the natural, cyclical nature of the economy and financial markets. Since the financial crisis in 2008-2009, markets saw the benefit of easy monetary policy from the Federal Reserve. It may take some time for markets to re-calibrate to tighter financial conditions, and increasing volatility in financial markets is likely to continue.

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Long Treasuries are represented by the Bloomberg US Long Treasury Index which measures the performance of debt issued by the US Treasury with a maturity greater than 10 years. Corporate bonds are represented by the Bloomberg Corporate Total Return Index which measures the performance of the investment grade U.S. corporate bond market. High yield bonds are represented by the Bloomberg US Corporate High Yield Bond Index which measures the, high yield, fixed-rate corporate bond market (securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below). TIPS are represented by the Bloomberg Barclays US Treasury Inflation-Linked Bond Index which measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.