GARDECAPITAL

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Asset Class Returns in Rising Interest Rate Environments

In June, the Federal Reserve raised the Federal Funds target rate by 75 basis points, to a range of 1.5% to 1.75%. This was the largest hike in the Federal Funds rate going back to 1994. The Federal Reserve's decision was eagerly awaited, as both investors and consumers are concerned about the current high rate of inflation.

Increases in the Fed Funds rate have been anticipated for some time, and we thought you might want to know: How have stocks and bonds fared during periods in which the Federal Reserve raised interest rates? Did a recession occur around the time of the Fed's actions? To answer these questions, the Garde Capital Portfolio Management Team assembled some data that we thought would be useful to share with you. Below, we detail some key points and outcomes for periods of rising interest rates.

Defining Tightening Cycles

For the purposes of this piece, we are defining "tightening cycles" as a period of at least six months in which the Fed Funds rate was either the same or higher than the previous month, ending when the highest rate in the cycle was reached. We identified 11 such periods going back to 1977. For periods lasting less than 12 months, returns were not annualized. For periods longer than 12 months, returns were annualized.

The 11 tightening cycles were as follows:

1. January 1977-December 1978
2. April-October 1979
3. July-December 1980
4. March-August 1983
5. March-August 1984
6. January-September 1987
7. March 1988-May 1989
8. February 1994-February 1995
9. June 1999-May 2000
10. June 2004-June 2006
11. December 2015-December 2018

How did Stocks Perform During Tightening Cycles?

When we look at stock returns during tightening periods (defined here as the time from the date of the first Federal Funds hike to the last), we see some encouraging data. Both large-cap and small-cap stock indices (defined here as the S&P 500 and the Russell 2000, respectively) saw almost uniformly positive returns during tightening cycles. The S&P 500 saw positive returns in 10 of 11 tightening cycles, with an average return of 12.16%. Similarly, the Russell 2000 saw positive returns in 10 of 11 tightening cycles, but with an average return of 14.63%. This makes intuitive sense, as small-cap companies are usually more volatile, but carry higher expected returns as a result of that higher volatility.

What About Value vs. Growth?

The financial press cannot seem to get enough of the rivalry between cheaper companies with higher dividend yields (value stocks) and faster-growing, more expensive companies with lower dividend yields (growth stocks). The Russell 1000 Value posted positive results in 9 of 11 tightening cycles, with an average return of 11.68%. The Russell 1000 Growth posted positive results in 10 of 11 periods, with an average return of 15.64%. This suggests that the recent outperformance of value stocks, and the struggling of growth stocks, may not last.

How did Bonds Perform During Tightening Cycles?

With the Bloomberg U.S. Aggregate Bond Index down approximately 11% year to date (as of June 2022), you might expect bonds to perform poorly in periods of rising interest rates. But bond returns were actually positive during 8 of the 11 tightening cycles. Their average return was 1.56%.

So why are bonds down this year? As a reminder, returns on bonds come from two sources: coupons and capital gains/losses. With very low yields on existing bonds (meaning low coupons as a percentage of the market value of the bond itself and low reinvestment possibilities of that coupon), there has been no "cushion" to soften the blow of lower prices. In other words, when bond coupons were 6%, 7%, or 8%, you as an investor could endure a capital loss (if you sold the bonds) of -4% or -5% and still come out ahead. Bonds will typically sell off in times of rising inflation as most bonds do not have an inflation adjustment to their coupons and purchasing power declines.

With smaller coupons to cushion the blow, investors have experienced negative returns so far this year.

Did a Recession Follow a Tightening Cycle?

We also examined what happened *after* tightening cycles. We reviewed the data to see whether a recession followed within a certain amount of time after the last hike to the Federal Funds rate during a tightening cycle. If we look 12 months forward in time after the end of a tightening cycle, we find that a recession occurred after only 3 of 11 tightening cycles. In other words, 8 of the tightening cycles did not cause a recession 12 months after the date of the last hike to the Federal Funds rate.

However, if we expand that timeframe from 12 to 24 months after the end of a tightening cycle, we find that a recession occurs after 7 of the 11 tightening cycles. This exercise raises some interesting questions. Was it the Fed's rate hikes that caused, for example, the 1999-2000 recession? Or was it the speculative excesses and fall in value of the "dot-com" stocks? Was it the Fed's rate hikes that caused the recession in 1979-1980, or did consumer demand dry up after years of sustained double-digit inflation?

Suggested Actions for Investors in Rate Hike Environments

To summarize, stocks and bonds generally fared well in the 11 tightening cycles that we identified going back to the late 1970s. Also, encouragingly, a diversified mix of these assets has held up exceptionally well. A portfolio of 70% stocks and 30% bonds ended up with a positive return in 11 of 11 total tightening cycles, with an average return of 8.92%.

We believe investors can take three simple steps in rate-hike environments to protect their portfolios:

1. **Stay invested**: Selling everything and moving your portfolio to cash may "feel" better during market turmoil. But with inflation near 9% this year, the purchasing power of your cash will continue to drop after accounting for inflation.
2. **Focus on long-term averages, not outlier results:** Both stocks and bonds have posted negative year-to-date returns for 2022. That is an outlier and will likely not be the case forever as cash must eventually find a positive return opportunity.
3. **Invest with specific goals in mind**: Stocks are intended to give us growth, and bonds are intended to give us stability and diversification from the volatility of stocks. Those dynamics have not changed despite higher-than-average inflation and geopolitical crises.

As always, if you have questions about how recent volatility affects your financial plan or retirement goals, please reach out to your advisor. Please find this newsletter and others on our website at www.gardecapital.com.

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