Portfolio Manager Insights

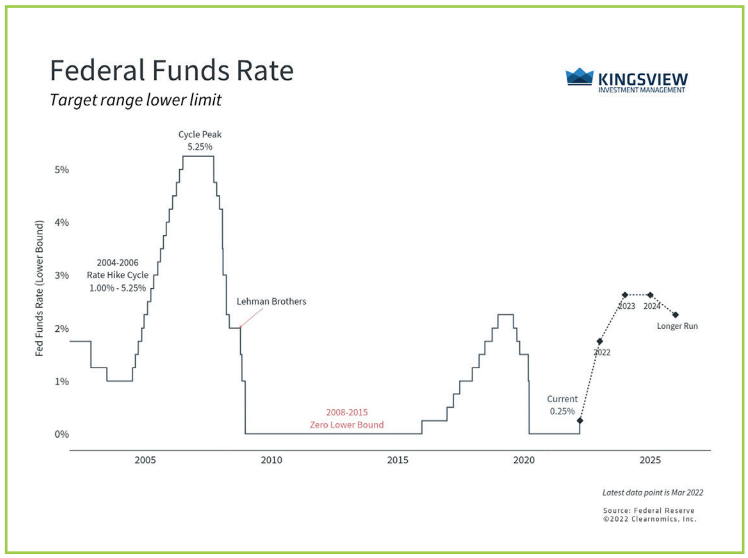
Weekly Investor Commentary | March 23, 2022
Investment Committee

The Federal Reserve has begun raising interest rates for the first time since 2018. This process is commonly referred to as "liftoff" because policy rates have remained grounded at zero percent since the Fed's pandemic rate cuts two years ago. While the initial market reaction has been positive, investors have faced a wide range of concerns as inflation has worsened and the conflict in Ukraine has intensified. How can investors stay focused on the long run as the Fed begins to tighten financial conditions?

Perhaps the most important fact to remember is that rate hikes are a normal part of the business cycle. The Fed's job is to keep the economy steady by achieving maximum employment and stable prices. In bad economic times, the Fed lowers rates to loosen financial conditions, making borrowing by individuals and businesses easier. In good times, the Fed raises rates to tap the brakes and prevent the economy from overheating. Thus, changes in monetary policy always occur in reaction to economic and market forces, and this time is no different in that respect.

What is different is that inflation is at its highest point since the early 1980s. Global supply chains still face many problems with important goods like semiconductors in short supply. Energy prices have spiked as a result of Russia's invasion of Ukraine, driving the domestic average price of gasoline past $4.25 a gallon for regular unleaded. Inflation has been much more persistent than many economists expected and it is directly impacting the wallets of consumers.

THE FED HAS BEGUN TO HIKE POLICY RATES



Key Takeaway:

1. **The Fed has begun to raise interest rates and is expected to do so throughout the rest of the year. In many ways, the Fed is "behind the curve" as it responds to elevated inflation.**

With this backdrop, it's no wonder that many have been calling for the Fed to tighten even as markets worry about the implications of higher rates. In this environment, there are two important reminders from history that are relevant to the quarters and years ahead.

First, the Fed rate hike in March is only the beginning of the process. The Fed's own projections show the federal funds rate reaching 1.75% by the end of the year. This would equate to six additional quarter-point rate hikes in 2022 across six remaining meetings. At his press conference, Chairman Jay Powell suggested that this timing is not a coincidence. Market expectations are somewhat higher, but all of these numbers are subject to revision based on the economic data between now and then.

In addition, the Fed has communicated that they may begin to reduce their balance sheet as early as their next meeting. Their holdings of Treasuries and mortgage-backed securities have grown to $9 trillion, double their post-2008 peak. By not re-investing the proceeds when bonds expire, and possibly selling certain bonds outright, the Fed will effectively tighten financial conditions further. If the Fed has direct control over short-term interest rates via the fed funds rate, they have indirect control over longer-term rates via the bonds they carry on their balance sheet. If the previous cycle is any indication, this process will occur in the background over the course of years.

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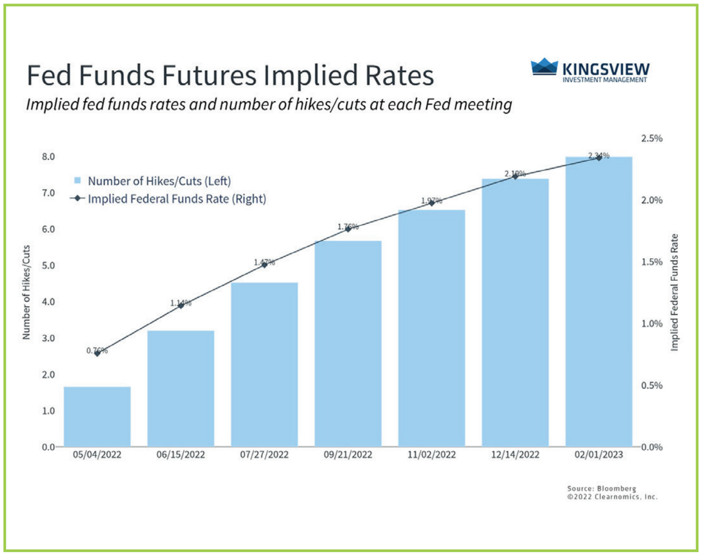
Second, history shows that Fed tightening is not usually something for investors to fear. Although markets performed well when Fed policy was loose, this is a matter of correlation rather than causation - both markets and the Fed are driven by strong economic conditions. Thus, it is not the case that Fed tightening directly causes bear markets, if they occur at all.

For all of the constant Fed-watching - including 2013's taper tantrum, 2015's Fed liftoff, last year's taper announcement, and the recent rate hike - markets have done well across cycles. To phrase it more strongly, investors who stayed invested throughout Fed policy cycles would have likely performed better than those who tried to time each decision. In fact, it can be argued that monetary policy will still be quite easy for some time to come. After all, what is a quarter-point rate hike when CPI is rising 7.9% year-over-year?

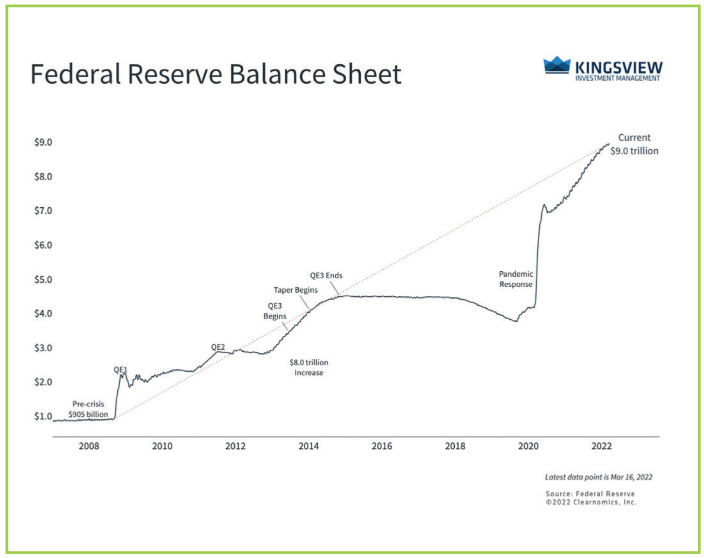
FOMC MEMBERS EXPECT SEVEN RATE HIKES IN 2022



Key Takeaway:

1. **Both the market and Fed expect at least seven total rate hikes this year. If this occurs, it would imply one rate hike at each remaining meeting in 2022.**

THE FED WILL SHRINK ITS BALANCE SHEET SOON



Key Takeaway:

1. **The Fed has also communicated that it is ready to "run off" its balance sheet. How it does so is still uncertain, but this tool does give it another option in tightening financial conditions, especially long-term interest rates.**

Of course, the biggest exception to this occurred during the 1970s and early 1980s when then-Chairman Paul Volcker was forced to tighten policy in order to tame inflation. Monetary policy does not magically cure inflation. Instead, it does so by reducing demand, thereby pulling prices down. During that period, the economy fell into recession but emerged with inflation under control.

While some are worried about a recession in the near future, this is not yet inevitable. Not only are the causes of today's inflation quite different but the broader disinflationary trends (e.g., technology, a glut of worldwide savings) are still at play. Even oil prices have come down from their recent peaks. So, while a recession is always possible and inflation could stay higher for longer, overreacting to these trends could be counterproductive to long-term investors.

Thus, the most important consideration for investors is whether or not their financial plans and portfolios support their long-term goals. Periods of disruption, which we've experienced throughout the first quarter of the year, can raise market concerns. But they can also create opportunities that benefit investors over time. At the moment, valuations are at their most attractive level in two years for the broader market and across certain sectors. While the past is no guarantee of the future, history reminds us that those investors who have the time horizon to be patient can often benefit from market uncertainty.