Which Assets Have Done Well During Fed Rate Hikes?

A look at the last five rate-hike cycles could offer some clues about the next one.

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Figure 1. How Have Key Asset Classes Performed during Past Periods of Fed Rate Hikes?

Total return by index during indicated periods of U.S. Federal Reserve rate hikes

	2-Year U.S. Treasuries	10-Year U.S. Treasuries	Bloomberg Aggregate	Short Corporate Bonds	Bank Loans	U.S. High Yield	Growth Stocks	Value Stocks
12/17/2015-12/20/2018	0.64	0.25	1.87	1.88	5.49	7.40	10.35	6.66
12/17/2015-12/20/2018	1.71	1.67	2.99	2.41	5.92	7.41	4.24	13.41
12/17/2015-12/20/2018	2.43	-0.09	1.40	3.23	2.14	**-2.06**	21.89	**-2.98**
12/17/2015-12/20/2018	1.13	**-7.64**	**-2.04**	1.84	9.33	**-1.71**	2.43	**-2.13**
12/17/2015-12/20/2018	3.44	1.41	3.41	5.65		8.95	11.59	16.94
Average Return	1.87	-0.88	1.52	3.00	5.72	4.00	10.10	6.38

Source: FTSE Russell, Bloomberg, ICE BofA Indices, Credit Suisse. Two-Year U.S. Treasury = ICE BofA Current 2-Year U.S. Treasury Index. 10-Year U.S. Treasury = ICE BofA Current 10-Year U.S. Treasury Index. Bloomberg Aggregate = Bloomberg U.S. Aggregate Bond Index. Short Corporate Bonds = ICE BofA 1-3 Year U.S. Corporate Bond Index. Bank Loans = Credit Suisse Leveraged Loan Index (historical data for this index is monthly; returns reflect nearest month-end). U.S. High Yield = ICE BofA High Yield Index. Growth Stocks = Russell 1000® Growth Index. Value stocks = Russell 1000® Value Index. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

With the U.S. Federal Reserve (Fed) widely expected to begin their QE tapering in early 2023, and inflation running uncomfortably higher than the Fed's target, the question for most observers is: When will the hikes begin, and how quickly will the Fed raise rates? As of mid-November, markets were pricing in five quarter-point hikes in the benchmark fed funds rate target by the end of 2023, with persistently high inflationary measures likely to introduce some level of uncertainty to these market expectations in coming months. Yet while expectations around the pace of hikes may shift in the coming months, it seems clear that investors need to prepare for a Fed hiking environment.

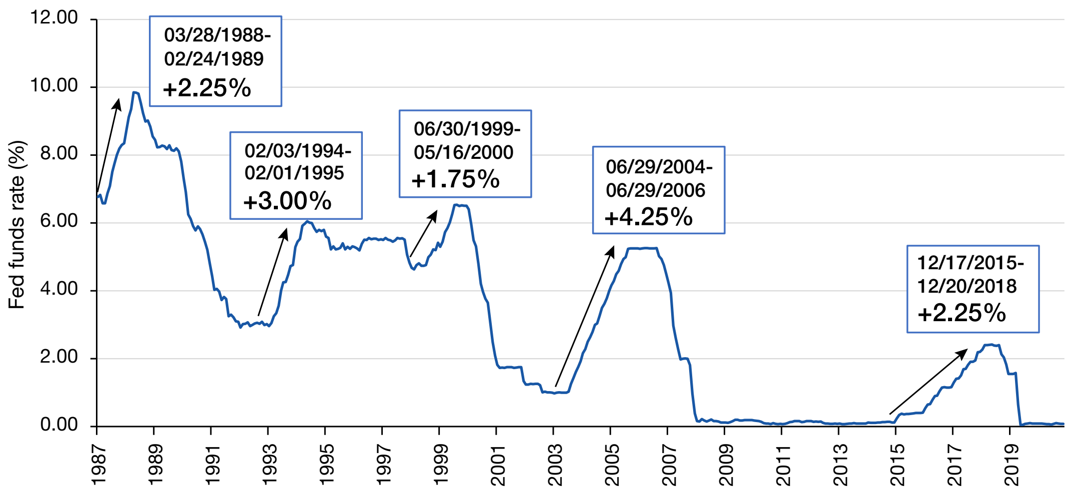
Fed Rate Hikes

What might this mean for investors? One way to assess the potential impact is to look at history, although past performance is not a guarantee of future results. In a previous *Market View*, we looked at how short-term bonds fared during previous Fed rate-hike cycles. Now, we will cast a wider net to look at the historical impact on other key asset classes.

But first, let's get our bearings. Figure 2 tracks changes in the fed funds rate over the past three-plus decades, and the most recent projections for where the rate could be headed.

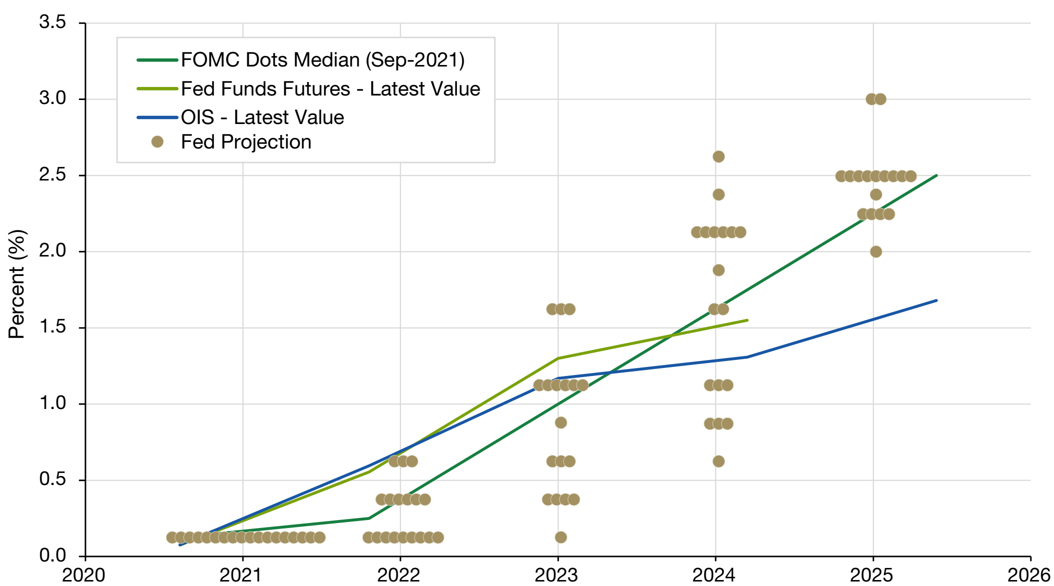
Figure 2. A Look at Past Increases in the Fed Funds Rate …

Effective fed funds rate, December 1987–October 2021



… and Where It May Be Headed Next

Expectations for rate increases in the United States, based on the Federal Reserve's "dot plot" projections, fed funds futures, and overnight index swap futures



Source: Federal Reserve and Bloomberg. Upper panel: Data compiled November 17, 2021. A basis point is equivalent to one one-hundredth of a percentage point; the figures accompanying arrows in the chart refer to the size of the total increase in the fed funds rate during the indicated period. Lower panel: Data as of 09/30/2021. FOMC = Federal Open Market Committee. The federal funds market consists of domestic unsecured borrowings in U.S. dollars by depository institutions from other depository institutions and certain other entities, primarily government-sponsored enterprises. The forward rate is a fixed/float interest-rate swap where the floating leg is computed using a published overnight index rate. The index rate (OIS) is typically the rate for overnight unsecured lending between banks, for example, the federal funds rate for U.S. dollars. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees and expenses, and are not available for direct investment.

In viewing the last five, distinct rate-hike periods, we see that the Fed has moved rapidly, as in 1994, and more gradually, such as during 2004–06. To see where the rate might be going in the months ahead, the lower panel of Figure 1 shows four sets of projections: 1) the actual rate projections (the so-called "dot plot") from 17 Fed board members; 2) a line indicating the median points from the "dot-plot" predictions; 3) the rate priced into the fed funds rate-futures market for the next three years; and 4) the expected fed funds rate based on overnight index swaps. We think there are two important take-aways here: all projections shown suggest a far less aggressive series of hikes than seen in previous cycles; and market expectations of where the fed funds rate will be after 2023 are lower than the Fed's own projections, even as the market anticipates a faster rate of hikes than the Fed dot plot over the next two years.

Now that we've mapped the interest-rate landscape, let's turn back to those last five Fed rate-hike periods and summarize the performance of various segments of the bond and stock markets during each period to assess how markets might react in the coming years. We present this performance in Figure 1 (first page).

What happened in each of the sectors? Here are some observations:

U.S. Treasuries: The performance of U.S. government bonds during the five periods in our survey was largely a function of the bonds' maturity. The lower duration, or price responsiveness to interest-rate changes, of a representative, two-year U.S. Treasury index allowed a positive return in every cycle and an average return of 1.87% during these periods. The story changes dramatically farther out on the yield curve, as an index of 10-year U.S. Treasury securities posted an average return of -0.88%.

U.S. Short-Term Corporate Bonds: The performance picture improved greatly outside the government-bond sector during the rate-hike periods in our survey. A representative index of one- to three-year U.S. investment-grade corporate securities handily outperformed both classes of U.S. Treasury securities in each of the past five Fed rate-hike episodes. The October 25 *Market View* cited earlier contains more detailed information on the historical outperformance of short-term bonds during periods of Fed rate hikes.

Bank Loans: There have been four Fed-tightening cycles since 1992, which is the beginning of reliable bank-loan index data. The episodes shown represent a range of rate hikes and time frames. In each case, bank loans (as measured by the Credit Suisse Leveraged Loan Index) performed well relative to the alternatives. While past performance is no guarantee that bank loans will again perform in a similar manner in the next rate-hike cycle, current forecasts indicate that initial rate hikes likely will coincide with periods of self-sustaining U.S. economic strength. More robust U.S. growth likely would also support the economically sensitive bank loan sector. Based on current valuation measures, the bank loan sector offers potentially attractive relative returns, almost regardless of when the Fed chooses to hike rates.

U.S. High Yield: In every period but the interval of June 1999–May 2000, the representative ICE BofA High Yield Index outperformed the Bloomberg U.S. Aggregate Bond Index. The high yield index also returned more than the two-year U.S. Treasury note during four of these five periods. If we combine all five periods, the high yield index provided an average return of 4.00%, compared to 1.52% for the Bloomberg Aggregate and 1.87% for the two-year Treasury index. The historical returns of the high yield index imply economic sensitivity, rather than rate sensitivity, for the asset class, and the importance of the higher yield that accrues over time. The criteria that favor rate hikes—stronger economic growth and moderately increasing inflation—seem to argue for U.S. high yield securities.

U.S. Equities: Over the five tightening cycles, the average returns of the representative Russell 1000® Growth Index (10.10%) and Russell 1000® Value Index (6.38%) signaled the historical resilience of the respective equity categories. Although many investors worry that growth equities can struggle during periods of rising interest rates, we can see that they have actually fared extremely well during periods of Fed hikes. Meanwhile, some investors fret about the potential for problems with value stocks, either from rising rates hurting high dividend stocks, or from low margins getting squeezed in inflationary environments. Yet, Lord Abbett Portfolio Manager Jeffrey Herzog recently noted that during inflationary periods, which tend to prompt Fed rate hikes, "value equities provide some defense because these firms' cash flows are more near term and therefore less impacted by discounting." Value equities are also often leveraged firms, and inflation tends to lessen the constraint of leverage through higher nominal growth rates in business activity, according to Herzog. Meanwhile, he notes, growth investing strategies that employ momentum factors "have also held up well when inflation is accelerating … momentum tends to reveal those companies that are able to maintain pricing power and navigate through changes in the economic environment."

Summing Up

The start of a Fed rate-hike cycle can engender uncertainty in financial markets, especially when a period of near-zero interest rates looks set to come to an end. Regardless of an investor's appetite for risk, there have been several investment strategies that historically have worked well during periods of Fed policy tightening. Investors may wish to review them as the day of rate-hike reckoning approaches.

—Edited by Will Andrews

Special thanks to Lord Abbett Messaging Strategist Umair Akhter and Associate Director, Corporate Services Quyen Lu for their help in the preparation of this article.

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