What the new Fed tightening cycle means for investors

The impact of further rate hikes on the bond market is both simple and complicated

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It has already been nine years since the last rate hike by the U.S. Federal Reserve. This means that there are currently a significant portion of investment professionals who have never experienced rising overnight rates and their effect on the stock market. A question we often get is: What should investors expect when the Fed starts a new hiking cycle?

The impact on the bond market is both simple and complicated. Generally, short-dated rates (including the one that influences mortgage rates in the U.S.) should move higher. Longer-dated rates, like the one on 10-year notes, typically react less promptly but move up nonetheless. As past experience has shown (see Chart 1), there is a clear relationship between the Fed funds and two-year rate, and short rates in fact tend to sniff out upcoming moves from the Fed. Using the past as a guide, we typically see a flattening yield curve once the Fed starts hiking rates. Still, since long rates also move in the general direction of the short rates, but with less amplitude, this also means that it is not unusual to see a steepening yield curve before the hiking cycle starts. Thus, it is fair to expect low returns or even losses on a bond portfolio during a tightening cycle, but the timing and amplitude both depend on how sensitive the long rates are at the time.

Stocks, however, are another story. In the previous tightening cycles (when the world was not coming off a recession so deep that central banks had to inject massive liquidity into the markets), the start to a hiking cycle was warranted by a strong economy that was starting to lead to rising inflation. As one can see from Chart 2, the start of the 1994 and 2004 hiking cycles coincided with the beginning of a sharp appreciation of profit margins in the U.S., as a stronger economy led to more pricing power for firms. In such environments, earnings growth usually accelerates, as was true in both the 1994 and 2004 cycles, and, as we saw in the 1994 cycle that pre-dated the dot-com boom, the price-to-earnings ratio (the price that investors are paying for every dollar of earnings) can also be pushed higher.

As we approach the probable lift-off date in September 2015, we ask ourselves if the current economic environment has enough similarities to the one that prevailed in 1994 or 2004. Many factors are worthy of an in-depth analysis, but we will place our focus squarely on profit margins.

A look at Chart 2 shows that not only are current profit margins already elevated, but they also seem to have topped out. Our studies have shown that profit margins have in the past few years been higher than at any other time since these data started being compiled, dating back some 65 years. The reason is quite simple: as the recovery remained unconvincing, businesses favoured buying back their own stocks instead of investing and hiring new employees. The average U.S. corporation saw its cost structure get in better and better shape, pushing profit margins to record levels. Now, as businesses are making up for lost time and have started hiring new employees at the fastest rate since the mid-1990s, we could see profit margins starting to gradually decline. Add to that the crying need for more investment in order to sustain labour productivity and we have reason to believe that a reversion to the mean is in order for profit margins south of the border, meaning that earnings growth will be under pressure.

On the lookout for cost-push inflation

While inflation is still below the 2% target, it does seem that the Fed is confident enough that inflationary pressures are forming under the surface. The question to ask is: will it be wages that push inflation higher, by forcing businesses to pass on the costs to their customers, or the strength of the economy, which will give firms more pricing power?

If it is the former, it would mean that we enter a cost-push environment where margins will be further squeezed. In such an environment, the start of a new hiking cycle (meaning less liquidity) combined with pressured earnings do not bode well for the stock market, and a bear market (a pullback of more than 20 per cent), although not our base case scenario, becomes a possibility. If it is the latter, and gains in employment combined with higher confidence result in a more dynamic economy, then the first hikes might spook investors and lead to a short correction, but we would consider such an event a buying opportunity.

In both cases, with the stock market trading above historical levels, we cannot help but think that it is headed for a bumpy ride, especially if we see an increase in the term premium on the bond market.

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