Money for Nothing: Should investors include fixed income securities in their portfolios ahead of a Fed rate hike?

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Conventional wisdom strongly suggests that investors should proceed with caution when deciding whether, and to what extent, fixed income investments should be a part of their asset allocation. This reticence is derived from the teeter-totter relationship between bond prices and rates (i.e. when rates increases prices decline and vice versa), a principle that is often the first thing investors learn when they begin studying the characteristics of fixed income securities. This simple valuation paradigm has struck fear into the hearts and minds of many investors as they watched the Federal Reserve gradually lower interest rates to zero percent in response to the bloodletting that occurred during our most recent financial crisis. Investors have collectively reasoned that, according to the basic relationship between bond prices and rates, interest rates will inevitably increase, in turn forcing bond prices sharply lower. As a result, they have concluded that their exposure to fixed income securities should be either minimized or eliminated. Is this thinking correct? More importantly, what, if any, insight can past interest rate hike campaigns provide investors regarding impending Federal Reserve interest rate decisions? The six most recent Federal Reserve interest rate tightening cycles, dating back to the late1970's, provide relevant comparisons to current macroeconomic thought among market experts, and will help answer this question.

As Exhibit 1 demonstrates, the Fed usually uses one of the following rationales as its basis for commencing a rate tightening cycle; inflation control or asset value disequilibrium. The presence of either jeopardizes the Federal Reserve's mission of creating price stability and promoting full employment. When previous macroeconomic environments and public policy decisions are compared to the current worldview, we are able to identify commonalities that provide insight into how the next rate hike cycle might affect fixed income securities.

Exhibit 1 Federal Reserve Rate Increase Campaigns

Period	Beginning	Peak	Primary Reason
Feb '77-June '81	4.6%	19.1%	High Inflation
Mar '83-Aug '84	8.5%	11.6%	Fear of the reemergence of hyperinflation
Nov '86-Mar '89	5.9%	9.9%	Weakening economy/Inflation
Feb '94-Apr '95	3.1%	6.1%	Asset valuations/Inflation
Jul '99-Jul '00	4.8%	6.5%	Asset valuations; especially equity valuations
Jun '04-Aug '06	1.0%	5.3%	Asset valuations; especially residential real estate & equity

Source: Federal Reserve, Deutsche Bank, iCM Capital Markets Research

Although each contained its nuances, the first three rate tightening cycles were primarily focused on reigning in above-average inflation and the associated fallout. The runaway inflation experienced during this period was in part a byproduct of the mainstream macroeconomic mindset of the preceding 20 years. Since at least the early 1960's, policymakers and academics feared a recession/stagnant growth more than inflation. Public policymakers at the time were confident in their ability to manage inflation and its associated effects. Loose monetary policy, oil shocks, deficits, and wars were considered manageable issues that existed along the path to greater economic growth.

Sumner Slichter promulgated the merits of "creeping" inflation while Paul Samuelson, the first American to win the Nobel Memorial Prize in Economic Sciences, argued an inflation rate below 2 percent is benign. In fact, his work with Robert Solow in constructing the Phillips Curve fed the misguided belief that politicians and policy makers could push an economy toward full employment at will by simply adjusting interest rates to a level that would create a low to moderate rate of inflation. The events of the 1970's, however, would challenge the notion of inflation as a benevolent dictator. Despite Federal Reserve Chairmen Arthur Burns and G. William Miller tightening interest rates repeatedly over the decade, driving the prime rate from 8.5 percent in 1970 to an astonishing 11.75 percent in 1979, inflation roared from an annualized rate of 0.96 percent to 4.2 percent. Investors believed the Fed was too wary to raise rates to a level high enough to stamp out inflation due to fear of dampening economic growth. It was not until Paul Volcker made the very unpopular decision to raise interest rates to stratospheric levels that market participants and policy experts finally concluded that the Federal Reserve considered price stability a priority. In fact, auto dealership owners mailed car keys to the Federal Reserve as a form of protest to symbolize all the unsold vehicles sitting on their lots as a direct result of Mr. Volcker's decision.

Perception is reality and runaway inflation was this period's hallmark, in large part due to the collective belief that the Federal Reserve placed a higher multiple on spurring economic growth vis-à-vis lower interest rates than stemming inflation with higher ones. If this sounds familiar, it should. A cursory review of economic headlines reveals the same debate occurring today among market experts. So if a dovish Fed recreates an environment similar to the one responsible for the first three rate hike campaigns, what would bond performances look like?

If history is a barometer, then bonds should perform better than most investors expect. Exhibit 2 displays the returns of seven popular fixed income indices during each Federal Reserve rate tightening campaign. For comparison, we also extended the performance period to include the three months immediately preceding the beginning of the rate increase cycle in order to capture any effect of markets anticipating higher rates. The surprisingly strong returns suggest that the reasons for interest rate increases are just as important as the rate increases themselves. As mentioned earlier, Federal Reserve Chairman Volcker's decisive action sparked confidence among fixed income investors, which likely catalyzed demand for fixed income securities given the now lower expectation for future inflation. Also, during the first three rate hike campaigns, there is a clear pattern of returns being higher during the period that includes the three months preceding the beginning of an interest rate hike campaign. This suggests that fixed income markets sensed higher rates were approaching and gained confidence that inflation was coming under control. In theory, this type of decrease in inflation expectations should benefit fixed income investors as it increases the real value of the coupon payments they receive.

Unlike the first three Federal Reserve interest rate tightening campaigns, the three most recent initiatives were primarily needed to curb rocketing asset values. In the late 1990's, The Federal Reserve, under Chairman Alan Greenspan's leadership, began increasing interest rates in an attempt to counterbalance the effects of a white-hot equity market. The S&P 500 closed out the 20th century with a 44.2 Shiller price-to-earnings ratio, a record that remains to this day. Since the 1870's, the only other point when the Shiller P/E broke 30 was the pre-Great Depression market crash. Similarly, the most recent round of interest rate hikes was intended to arrest runaway real estate and equity values. During these environments, much like those that were inflation-centric, fixed income markets faired reasonably well, with the negative returns of longer-dated government bonds during the 1994-1995 rate hike campaign being the only exception. Also, in all three instances, the Barcap Aggregate Bond Index produced positive results.

Exhibit 2 Total Return (%)

Performance of Various Fixed Income Indices during Federal Reserve Interest Rate Tightening Campaigns

Fed Rate Hike Cycle *Fed Rate Hike Cycle+ preceding 3 months*	Barclay's Aggregate Bond Index	Barclay's Credit Bond Index	Barclay's Intermediate Credit Index	Barclay's Long Credit Index	Barclay's U.S. Corporate Investment Grade	Barclay's Long Government Index	BofA Merrill Lynch US Mortgage Backed Securities Index
Feb-77 - Jun-81	11.68	1.91	18.8	-4.39	1.91	-3.76	3.85
Nov-76 - Jun-81	*14.23*	*5.03*	*21.66*	*-1.24*	*5.03*	*-0.61*	*6.67*
Mar-83 - Aug-84	9.87	9.88	12.15	8.29	9.88	2.86	9.74
Dec-82 - Aug-84	*15.48*	*16.35*	*18.72*	*14.68*	*16.35*	*7.45*	*17.61*
Nov-86 - Mar-89	14.12	16.03	15.45	16.74	16.03	9.39	17.07
Aug-86 - Mar-89	*17.47*	*20.05*	*19.13*	*21.04*	*20.05*	*12.16*	*21.03*
Feb-94 - Apr-95	2.03	1.5	2.48	0.27	1.5	-2.37	4.13
Nov-93 - Apr-95	*3.08*	*2.8*	*3.94*	*1.36*	*2.8*	*-2.33*	*6.04*
Jul-99 - Jul-00	5.51	4.25	4.66	3.58	4.25	8.12	5.76
Apr-99 - Jul-00	*4.59*	*2.62*	*3.81*	*0.53*	*2.62*	*5.42*	*5.13*
Jun-04 - Aug-06	9.63	9.92	8.42	15.26	9.78	16.13	10.82
Mar-04 - Aug-06	*7.15*	*6.74*	*5.91*	*9.74*	*6.56*	*10.67*	*9.03*

Source: iCM Capital Markets Research, MPI Stylus

The somewhat surprising commonality among all six rate increase campaigns was solid performance across fixed income securities. Despite the logical underpinning of the teeter-totter valuation relationship between bond prices and interest rates, fixed income securities proved to be solid investments during Federal Reserve interest rate hike campaigns. While many factors affected the performance of bonds during these periods, the Federal Reserve's willingness to curb the effects of inflation and investor confidence both played prominent roles, driving interest rates and bond prices higher. Investors seem to misunderstand that <u>the reason(s) for an interest rate increase is/are more important than the direction of rates.</u> If the Federal Reserve is raising rates because it is part and parcel to the fight against inflation or because the economy is strong, then investors are likely to view bonds more favorably. If the Fed raises rates to preemptively fight rising inflation today, then market participants will often view this measure favorably and interpret it as disinflationary for bond markets over the longer-term because this policy will help protect the purchasing power of the interest payments.

Despite investor fear of rising rates, we believe valuations across the fixed income landscape remain fair to marginally expensive, based on the belief that markets have modestly underestimated long term inflation. This does not mean that fixed income assets should be avoided or reduced in any meaningful way, rather a portfolio should be properly allocated to capture the portions of the fixed income markets that present the most attractive opportunities for future risk-adjusted returns. This is reflected in the current positioning of our portfolios, which are aligned from a sector perspective with the Barclay's Aggregate Bond Index, but hedged in terms of our rate exposure at the front end of the curve. If you are interested in learning more about our investment views please feel free to reach out to one of our team members.

Sources:

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