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Fed Rate Hikes: A Tailwind for Bonds?

Even if the Fed keeps raising short-term interest rates, bonds may stand to benefit.

The US Federal Reserve (Fed) is one of the most influential drivers of global financial markets, so its monetary policy decisions and actions are critically important. Sometimes, however, the market implications may not be as clear-cut as they might seem.

For example, conventional wisdom tells us that as interest rates rise, existing bonds decline in value. But today's macro environment is more complex than this simple rule because of the current mix of stubbornly high inflation, weakening economic growth, and a not-so-remote risk of recession. Against this backdrop, I believe higher-quality, long-duration[1] fixed income assets may prove resilient even if the Fed continues raising short-term interest rates for many months to come.

The Fed Is Following, Not Leading the Markets

The Fed hiked rates by 75-basis points[2] (bps) at its July 27 Federal Open Market Committee (FOMC) meeting, as widely expected. By contrast, the Fed's 75-bps rate hike in June 2022 *overshot* expectations for a 50-bps increase. However, I would argue that the central bank's surprise move in June actually lagged the latest available US inflation data, as it came *after* an eye-popping headline Consumer Price Index[3] (CPI) reading of 9.1% and a spike in consumer inflation expectations.

The takeaway? Neither the market nor the Fed has a crystal ball, but if past is any prologue, it's quite possible that the Fed will continue to follow the markets (based on incoming data), not lead them. But that's not necessarily bad news for bondholders with longer-term investment horizons.

What's the Case for Long-Duration, High-Quality Bonds?

Interestingly, while federal funds rate[4] futures contracts are signaling that the market believes the Fed's terminal rate for 2022 will be around 3.25%, December 2023 futures contracts are currently trading closer to 2.75%, suggesting a belief that the Fed will reverse course and begin cutting rates by mid-2023 **(FIGURE 1**). Optimistic though it may be, if that forecast is indeed correct, it would certainly make a good case for owning US duration—particularly longer-duration, higher-quality bonds. Of course, the market could be wrong.

But even if the market is wrong, I think the Fed is more likely to hike rates aggressively rather than too timidly. (In the FOMC press conference following the latest 75-bps hike, Fed Chair Jerome Powell

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Key Points

- Against today's macro environment, I believe higher-quality, long-duration fixed-income assets may prove resilient even if the Fed continues raising short-term interest rates.
- It's quite possible that the Fed will continue to follow the markets, not lead them. But that's not necessarily bad news for bondholders with longer-term investment horizons.
- Since the Fed is more likely to hike rates aggressively, longer-term bond yields could fall as investors foreshadow more meaningful economic slowing in response to Fed tightening.

commented that "doing too little raises the cost if you don't deal with it in the near term.") In that case, I believe longer-term bond yields could fall as investors foreshadow more meaningful economic slowing in response to Fed tightening. We've already seen early evidence that the US economy is feeling negative impacts from the Fed's intense focus on breaking inflation's back, even at the expense of growth:

- Rising mortgage rates have helped to cool housing market activity, while many US consumers appear to be reining in their spending.
- More recently, a preliminary US composite Purchasing Managers' Index[5] for July fell to 47.5—a reading consistent with recession.
- The cumulative impact of the unprecedented speed and magnitude of the Fed's balance-sheet reduction has yet to be determined.

The risk is that the Fed could back off from policy tightening in the face of weak growth, even while high inflation persists. In that case, I think the market would question the Fed's credibility and signal as much with higher long-term bond yields—a risk the Fed is unwilling to take, in my view.

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FIGURE 1

Fed Funds Futures Are Signaling That the Fed Will Start Cutting Rates in 2023

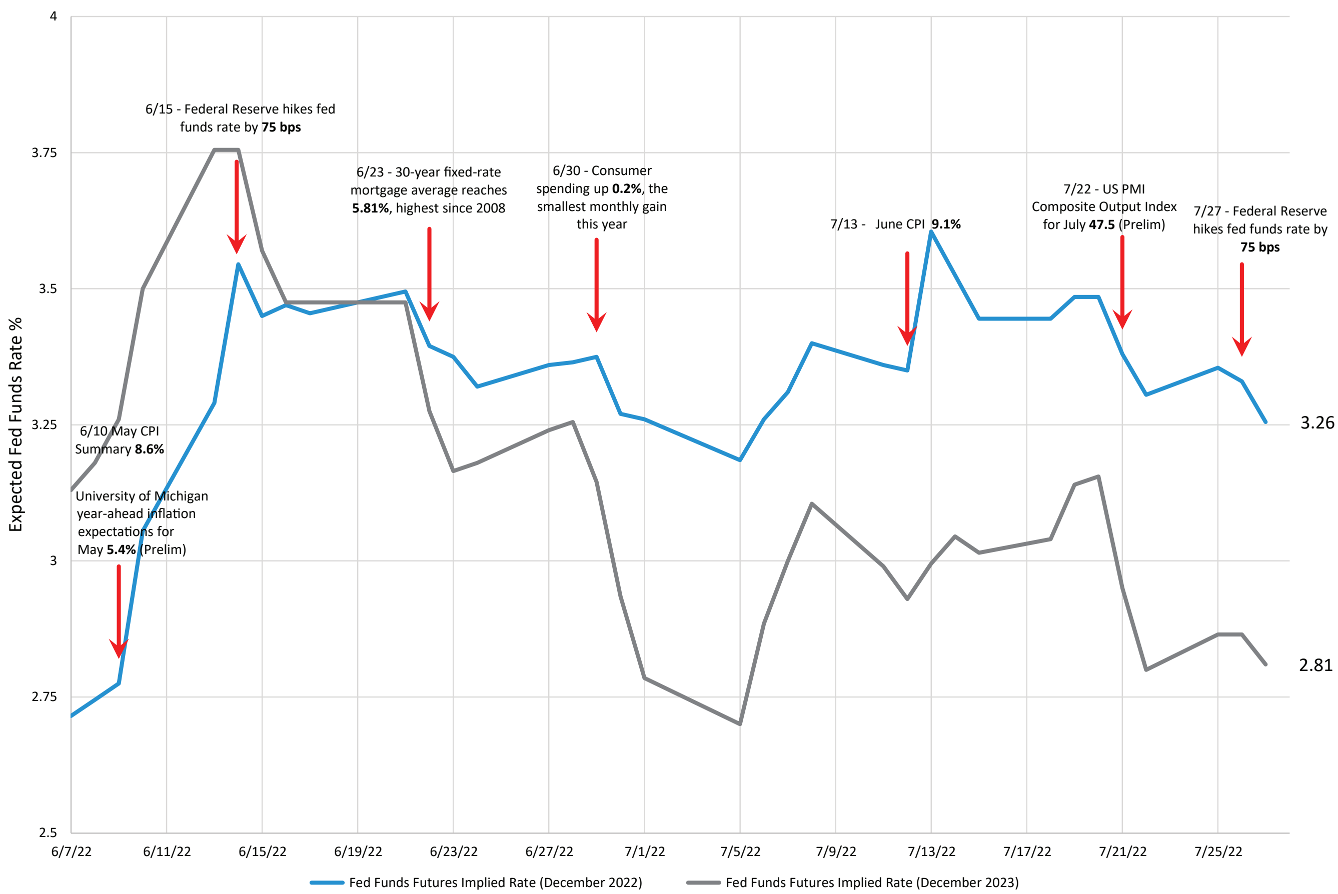

Chart data as of 7/27/22. Arrows are visually represented one day early as economic data is released before the futures market opens. Sources: Bloomberg, US Bureau of Labor Statistics, University of Michigan, St. Louis Fed.

Investment Implications

- **Duration looks decent** – Markets are still trying to figure out the most likely path of short-term US rates, but assuming inflation persists well above the Fed's target, I believe the central bank may be more apt to hike rates too much rather than too little in the period ahead. Thus, in terms of portfolio positioning, I currently favor being at least neutral duration assets relative to US fixed-income benchmarks.
- **60/40 may make a comeback** – The traditional 60/40 equity-bond mix has fallen into disrepute amid negative double-digit returns, driven by positive correlations between the two asset classes during this high-inflation period. However, our research shows that those correlations tend to be negative when inflation is falling. If the Fed sticks to hiking until inflation is sustainably lower, bonds may resume their role as a potential hedge against equity sell-offs—another reason to consider owning duration in US bonds.
- **Consider selectively adding exposure to high-quality bonds** – US Treasuries, high-quality sovereign bonds, and investment-grade corporate bonds are attractive candidates for adding duration exposure to portfolios, in my view. For tax-sensitive investors, municipal bonds can also serve this role, especially as many state and local governments are still flush with cash from COVID-related stimulus measures.

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Talk to your financial professional about how you should position your portfolio amid market uncertainty.

[1] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[2] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[3] The Consumer Price Index is a measure of change in consumer prices as determined by the US Bureau of Labor Statistics.

[4] The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

[5] The Purchasing Managers' Index is an index of the prevailing direction of economic trends in the manufacturing and service sectors. A reading above 50 suggests economic expansion while a reading below 50 suggests economic contraction.

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