When Rising Rates Bite

It's already been a volatile start to 2023 as companies and markets adjust to higher interest rates. Tighter credit conditions may add to the likelihood of recession.

Insight from sub-adviser
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Key Points

- Higher interest rates have helped expose recklessness and speculation, with growth stocks, cryptocurrencies, and a handful of banks feeling the impact.
- The current market environment seems reminiscent of the 2002 post-dotcom downturn, which suggests there's more work to do on earnings expectations and valuations.
- Persistent inflation may prevent the Federal Reserve from pivoting as quickly as markets are now pricing. A softening labor market could signal that Fed policies are working.

I write this in April 2023 after a turbulent month for markets in which the banking sector has been at the eye of the storm once again.

Comparisons have reasonably been made to previous periods such as the Global Financial Crisis of 2008 and the dotcom bubble at the turn of the century, both of which I had the dubious pleasure of working through.

It reminds me of the often-cited quote from author Mark Twain, that "history never repeats itself, but it does often rhyme." Past experience certainly helps in identifying the rhyme. But in recognizing the idiosyncrasies that make today's markets different, a fresh pair of eyes is helpful.

Without doubt, we can draw some lessons from previous cycles; most notably, that when interest rates rise, this typically spells trouble for economies and markets.

The lags between policy changes and the economic effects are uncertain, but one of the ways in which higher interest rates bite is by exposing recklessness and speculation. This leads to a cooling of animal spirits, lower market valuations, and slower economic activity overall.

First to fall were growth stocks and cryptocurrencies, then came the UK's bond crisis in 2022.[1] The most recent victim of higher rates was the former darling of the tech start-up industry, Silicon Valley Bank. Falling deposits forced the bank to crystallize the losses on its bond portfolio and, as I write, uncertainty over bank funding costs is affecting both the US and European banking sectors.

What's also a common occurrence as rates rise is that seemingly idiosyncratic challenges facing a particular company can cause a domino effect to other companies as investors take a closer look at the risks across their portfolios. For example, the troubles at Silicon Valley Bank led to a reassessment of risk across US regional banks and beyond (i.e., Credit Suisse). The common link: these banks were seeing falling deposits.

These occurrences evoke memories of 2007 and 2008—although, compared to back then, large banks are now more conservative and capital is considerably higher. Nevertheless, we see all of this as evidence that higher interest rates are leading to tighter credit conditions and that strains on the US regional banks are likely to continue.

As a consequence, our multi-asset team favors government bonds and higher-quality credit as we expect the US economy to slow and move into recession later this year. We remain cautious on equities; while valuations have improved, the cyclical clouds are darkening.

To the extent that we can draw historical parallels, I continue to think that the 2000-2003 roadmap is useful.

Back then, we had a bubble in growth stocks pricked by higher interest rates. The first phase of the bear market (2000 to 2001) entailed a de-rating[2] across markets as valuations adjusted to higher rates. The second and final phase in 2002 was more company-specific, with fraud at Enron, for example, causing uncertainty about the level of corporate earnings and further weakness in markets. As it's often said: as the tide goes out, we find out who is not wearing any shorts.

The current market environment reminds me of the summer of 2002 and suggests there's a bit more work to do on corporate-earnings expectations and equity valuations; but remember that some de-rating has already occurred.

But we also have to think about how each cycle is different. I've talked a lot about regime change and how we should think about what we did in the 2010s and do the opposite.

One challenge is that, in the 26 years I've been analyzing markets, I haven't seen such a persistent problem with inflation and the Federal Reserve (Fed) may not be able to pivot policy as quickly as the market is now pricing. On this front, signs of softening in the US labor market would reassure investors that the Fed is close to getting its job done and would remove a significant obstacle for markets.

Talk to your financial professional to help protect your portfolio against rising interest rates.

[1] In the UK, government bonds are known as "gilts." The September 2022 crisis commonly referred to in the UK as the "gilt crisis" involved a collapse in the value of British gilts in response to negative market reaction to a controversial budget proposal from the Conservative government of former Prime Minister Liz Truss. As traders rushed to sell 30-year gilts, pushing up their yields and decimating their value, it spawned a vicious cycle in which heavily leveraged pension-fund managers were forced to sell their gilts in response to margin calls, which in turn forced the Bank of England to step in and provide emergency liquidity.

[2] De-rating refers to a downward adjustment in the rating of a corporation, or to a negative change in sentiment.

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