

The Effects of Rising Interest Rates on Fixed Income Markets

Perspectives | April 2022

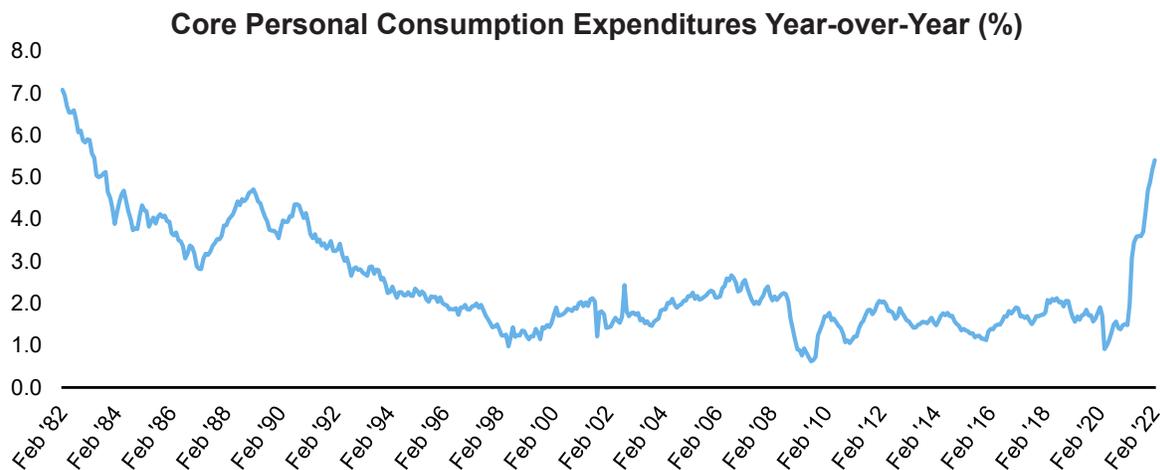


The consensus view is that the Federal Reserve (Fed) will raise interest rates throughout the coming year. For many, the question is how often and by how many basis points. In this Special Report, we detail the monetary policymaking body's view on the economy, the market's views on monetary policy and the historical path of rate cycles to shed light on what may lie ahead for the fixed income markets.

The Reason the Federal Reserve (Fed) Is Poised to Raise Rates

For the first time since 2015, the Fed increased the Fed Funds Target rate at their March Federal Open Market Committee (FOMC) meeting. Of course, today's environment is markedly different than 2015 and other recent cycles because inflation is the highest we have seen in decades. In addition, some measures of debt are also at multi-decade highs, while central bank policy interest rates are still near historic lows in many countries across the globe, including the U.S.

In response to the economic fallout from the COVID-19 global pandemic shutdown, the Fed cut short-term interest rates to near 0%. The Fed also expanded its balance sheet to around \$9 trillion primarily through the purchase of Treasury and agency mortgage-backed securities (MBS). This extremely accommodative monetary policy, combined with the trillions of dollars spent from stimulative fiscal policy, helped support the domestic economy and ultimately led to improved economic conditions. With households on solid footing, there has been increased demand for goods and services. Unfortunately, this increase in demand, along with supply constraints resulting from ongoing COVID-19 challenges and the conflict between Russia and Ukraine, are key factors that have led to the highest inflation since the 1980s.



Source: Bloomberg.

As shown in the chart above, Core Personal Consumption Expenditures (PCE), an inflation indicator often mentioned by the Fed, ran at 5.4% year-over-year (YoY) in February. Meanwhile, a broader measure of inflation, the Consumer Price Index (CPI), reached 7.9% YoY in February. In addition to actual rising inflation, expectations of future inflation have also risen. Market-based indicators of inflation expectations, measured by breakeven rates calculated from Treasury Inflation-Protected Securities (TIPS), as well survey-based measures (Survey of Consumers – University of Michigan, for example), have sharply risen over the last year or so.



In order to combat this, the Fed ended purchases of Treasury and MBS in early March and plan to embark on a series of interest rate hikes throughout 2022.

The Fed's View of the Economy and the Path of Interest Rates

Recent comments by the Fed have turned more "hawkish," meaning that it's ready to tighten policy in an effort to slow growth sufficiently to tamp down inflation and future expectations of inflation. A review of their most recent economic projections indicate perceived strength in the economy with above trend growth (2.8%), unemployment on the historically low side (3.5%) and inflation well above their 2% target (4.1%) for 2022.

Summary of Economic Projections as of March 2022				
	2022	2023	2024	Longer Run
Real GDP	2.8	2.2	2.0	1.8
Unemployment Rate	3.5	3.5	3.6	4.0
Core PCE	4.1	2.6	2.3	--
Fed Funds Rate	1.9	2.8	2.8	2.4

Source: Federal Reserve.

A look at the Fed's "Dot Plot" shows the median projection with six additional rate hikes in 2022 and another four in 2023. Their longer run projection for the neutral target rate is near 2.5%.

Market Views on Monetary Policy

Currently, markets are expecting an extended series of interest rate increases. Futures on Fed Funds are currently pricing in eight to nine additional hikes this year, with an implied Fed Funds Rate of 2.5%. Economists and strategists are now leaning toward expecting 50 basis point increases at the coming FOMC meetings. This type of increase is not without precedent. The last increase of 50 basis points was in 2000. The Fed also increased rates by 50 basis points or more on three occasions during the 1994 cycle. In 1983, it started with a 100 bps increase. However, the 1980s were a more volatile time for interest rates as the Fed Funds target rate ranged between 5% and 20%.

With Fed asset purchases now ended, market participants are now starting to project a balance sheet runoff soon. This would be a notable difference from the last rate hiking cycle when the Fed waited a few years before "quantitative tightening". There is also some possibility of the Fed actively *selling securities* to reduce their balance sheet.

A Look at the Last Four Rate Hiking Cycles For Historical Perspective

Since 1990, there have been four distinct interest rate hiking cycles (excluding a 50 bps adjustment of rates in 1997).

Cycle	First Increase	Last Increase	Hikes	Total Basis Points	Start	Finish
1994	Feb '94	Feb '95	7	300	3.00%	6.00%
1999	Jun '99	May '00	6	175	4.75%	6.50%
2004	Jun '04	Jun '06	17	425	1.00%	5.25%
2016	Dec '15	Dec '18	9	225	0.25%	2.50%

Source: Bloomberg.

1994 Cycle — The Fed increased rates seven times for a total of 300 bps. This included three increases of 50 bps and one of 75 bps. The duration of the hiking cycle was about one year.

2000 Cycle — The Fed increased rates six times for a total of 175 bps. The last increase was 50 bps. The duration of the hiking cycle was about one year. Tech stocks peaked in March 2000.

2004 Cycle — The Fed increased rates 17 times and 425 bps. Each FOMC meeting saw an increase during the two-year cycle. The Great Financial Crisis commenced in 2007 following the cycle.

2016 Cycle — The Fed increased rates nine times and 225 bps. The FOMC initially raised rates in December 2015, and then paused for one year before hiking rates again in December 2016.

At the moment, the consensus view for this cycle appears to be something closer to the 2016 cycle in terms of the terminal Fed Funds rate (the target rate when the Fed ends its cycle). Former New York Fed president Bill Dudley and others have suggested a more aggressive approach to increasing rates at each meeting, similar to 2004, resulting in an ending rate between 3% and 4%.

A unique factor this time around is that economic indicators are stronger to start this cycle relative to previous hiking cycles. While growth is somewhat uneven due to the ongoing impact from COVID-19, it is expected to remain at or above trend, at least for the next year. Inflation and inflation expectations remain high while unemployment is low.

Cycle	Trailing 1 Year GDP	Core PCE	Unemployment Rate
1994	3.4%	2.3%	6.5%
1999	4.7%	1.4%	4.3%
2004	4.2%	2.1%	5.6%
2016	1.9%	1.1%	5.0%
March 2022	5.7%	5.4%	3.6%

Source: Bloomberg.

Cycle	Start of Cycle					Change after 1 Year				
	FDTR	2 Year	5 Year	10 Year	30 Year	FDTR	2 Year	5 Year	10 Year	30 Year
1994	3.00%	4.4%	5.3%	5.9%	6.4%	3.00%	3.0%	2.1%	1.6%	1.3%
1999	4.75%	5.5%	5.6%	5.8%	6.0%	1.75%	0.9%	0.5%	0.3%	-0.1%
2004	1.00%	2.7%	3.8%	4.6%	5.3%	2.00%	1.0%	-0.1%	-0.7%	-1.1%
2016	0.25%	1.0%	1.7%	2.3%	3.0%	0.50%	0.1%	0.3%	0.3%	0.2%
March 2022	0.25%	1.8%	2.1%	2.1%	2.5%	--	--	--	--	--

(Date for last line is March 16, 2022 and shows the start of the next cycle).



Potential Effects on Fixed Income Markets

YIELDS

Treasury rates have moved sharply higher in recent months in anticipation of the Fed raising policy rates. Money market securities yields have also repriced higher, building in higher expected short term rates. Front-end Treasury notes maturing in 2-3 years are more sensitive to the outlook for future hikes and have seen their yields increase the most for the first three months of the year. These maturities could continue to see their yields increase over the course of this year. That said, there is a wide divergence of views regarding how high interest rates will go. The expected level of terminal Fed Funds will have an impact on the yield for longer maturities (the 10-year note for example), as will the trajectory for growth and inflation.

YIELD CURVE CONSIDERATIONS

In addition to yields still being relatively low compared to historical standards, the shape of the yield curve is relatively flat compared to the beginning of previous tightening cycles. One measure of the shape of the yield curve is the spread relationship between 2- and 10-year Treasury yields. When the Fed hiked rates last month, the spread (difference between the 10- and the 2-year yield) was 25 bps. During the previous four cycles, the spread has averaged 125 bps when the Fed started hiking rates.

The typical response of the curve during the first year of tightening by the Fed is to see this relationship narrow or flatten (shorter-term yields rising more than longer-term securities). This might prove to be more challenging considering the current flatness of the curve. There are some Fed officials that have discussed more actively shrinking the Fed's balance sheet, which could also impact the slope of the curve if that includes sales of longer-term Treasuries or MBS.

SPREADS

When Treasury yields are beginning the process of moving higher during a typical cycle, spread products (corporates, asset-backed securities, MBS, etc.) tend to outperform Treasuries. The yield, or the additional income one earns over a comparable Treasury security, acts as a partial cushion against the negative change in market value from higher interest rates. In addition, the Fed is generally moving rates higher with the backdrop of improving economic conditions, which would support performance in these sectors.

An example of our cautious yet constructive view would be the corporate sector. The strength in the economy and supply dynamics support fundamentals and valuations in the sector. However, increased rate volatility has the potential to create periods of "risk off" when spreads widen. Overall, we expect higher returns in the corporate sector relative to comparable Treasuries.



We are more cautious with MBS based on starting valuations. Over the last couple of years, this sector has benefited from the Fed’s purchase of \$40 billion per month of MBS. This led to historically tight valuations (narrow spreads) in the sector. With purchases coming to an end, spreads have started to widen from their historically tight levels. We expect the widening to continue, which should eventually lead to opportunities to add in the future.

Conclusion

While environments where the Fed increases rates have some similarities, they tend to follow unique paths and result in outcomes tied to the particular circumstances and market reaction. This particular cycle has two powerful dynamics. One is inflationary forces with a level that we have not seen in decades. The other is a strong, but uneven economy with a tremendous amount of uncertainty due to shocks such as the conflict between Russia and Ukraine and lingering impacts from COVID-19. These unique market conditions pose daunting challenges for the Fed to get it right — to slow inflation while not triggering a recession. So far, the market is responding appropriately by pushing rate higher, but analysts differ widely on the ultimate outcome.

Higher rates and a flatter curve are typical outcomes during periods of rising rates, and that is what we expect to continue as long as the Fed is committed to an aggressive pace of rate hikes. Returns on corporates and other spread sectors have generally been better than those on Treasuries during these periods. While some patterns will most likely repeat, investors will need to be nimble and flexible in their approach to navigating today's unique market challenges.

To learn more or discuss in greater detail, please contact us:

James Sims, CFA
Senior Portfolio Manager
simsj@pfmam.com

PFM Asset Management LLC (“PFMAM”) is an investment adviser registered with the U.S. Securities and Exchange Commission and a subsidiary of U.S. Bancorp Asset Management, Inc. (“USBAM”). USBAM is a subsidiary of U.S. Bank National Association (“U.S. Bank”). U.S. Bank is a separate entity and subsidiary of U.S. Bancorp. U.S. Bank is not responsible for and does not guarantee the products, services or performance of PFMAM.

NOT FDIC INSURED : NO BANK GUARANTEE : MAY LOSE VALUE