INVESTMENT STRATEGY INSIGHTS

Rate Hike Ripples

January 18th, 2022

The Fed's Supply-Chainflation Response

- Despite the likelihood that supply chain pressures ease, the Fed is accelerating monetary tightening to tame inflation

Bonds: Expectations Matter

- Rising rates often have less of an impact on bond returns than expected; it is the unexpected rate hikes that matter

Equity Resilience & Internal Shifts

- Equity markets should prove resilient to initial Fed tightening, but relative performance of growth and value is likely to shift

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Rate Hike Ripples

The Fed's Supply-Chainflation Response

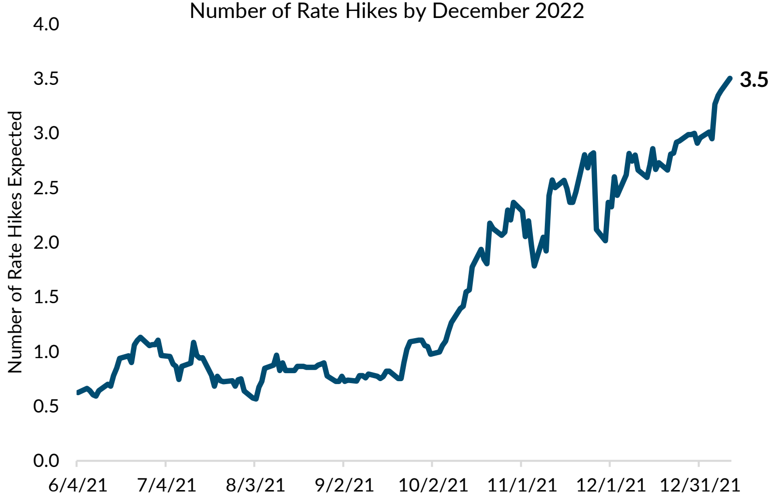
- **Inflation Heat.** The U.S. Consumer Price Index (CPI) increased 7.0% year-over-year in December, the highest annual growth rate for CPI in nearly forty years. On a month-over-month basis, CPI rose 0.5% for December, down from November's 0.8%, signifying a potentially slowing rise in CPI. Economists broadly expect inflation to be lower in 2022, but the skeptics continue to be reinforced by the magnitude of inflation in recent reports.
- **Supply Chain Watch.** Ongoing supply chain disruptions remain a key culprit behind hotter-than-normal inflation. According to Blue Chip Economic Indicators, 75% of economists expect supply chain bottlenecks will ease within the next 9 months, leading to an easing of inflationary pressures. Various indices of overseas freight rates (the WCI Freight Index, the Baltic Dry Index and the Shanghai Containerized Freight Index) have provided mixed signals with some recently declining from near-term highs.
- **The Fed's Response.** The Fed has already initiated the tapering of its bond purchases and even accelerated this taper, but now the discussion is turning to the timing of their first rate hike. Fed officials have been making public statements in support of hiking rates in March, often a way for the organization to signal intentions and both prep and test the market for such a decision. Starting in March raises the likelihood of four rate hikes this year, up from the three previously expected. Fed funds futures are now pricing in an ~86% chance of a rate hike by March, up from 75% last week. The same futures market is now pricing in an 83% chance of at least three rate hikes and a 55% chance for four or more rate hikes in 2022.

> *Despite the likelihood that supply chain pressures ease, the Fed is accelerating monetary tightening to tame inflation*

Chart of the Week:

Faster Fed Rate Hikes Expected

Market-Based Fed Funds Rate Expectations: Number of Rate Hikes by December 2022



Source: Glenmede, Bloomberg — Data through 1/14/2022

Data shown is the progression of expectations through time for the number of rate hikes that investors are predicting by December 2022. Expectations are based on pricing in federal funds futures markets. Actual results may differ materially from expectations.

*Blue Chip Economic Indicators is a monthly survey and associated publication by Wolters Kluwer collecting macroeconomic forecasts related to the economy of the United States.

Rate Hike Ripples

Bonds: Expectations Matter

- **Expected vs. Unexpected Rate Hikes.** Bond Markets 101 – as interest rates go up, the price of a bond with a set coupon should decline – may be too simple. A historical analysis of bond returns in periods of changing rates shows a looser relationship. The difference is in which rate is changing. Rising short-term fed funds rates often do not result in the same change in longer rates as bond markets have a tendency to price in expected changes in short-term interest rates.
- **Yield Curve Expectations.** The Fed has yet to start raising rates, so short term interest rates remain effectively near zero, but the interest rate on 10-year Treasuries has risen to around 1.75%. Markets have already moved to price in several post-pandemic rate hikes, although they will likely be spread over multiple years. Whether this is too much or too little will ultimately depend on the terminal level for fed funds and whether the economy can bear it, but it will be a while before we are able to answer this question.
- **What Does This Mean for Investors?** Going forward, investors should hold back from worrying too much about rising rates. Their exposure is seemingly limited to unexpected rate hikes, which should now be less likely since expectations have increased. Further, the rise in rate hike expectations has led to higher yields, which should make bonds more attractive. Instead of worrying about rising rates, investors should see bonds for what they are – a fixed yield and a ballast against equity market declines. They may not yet deserve an overweight in portfolios, but they do deserve an allocation.

Rising rates often have less of an impact on bond returns than expected; it is the unexpected rate hikes that matter

Equity Resilience & Internal Shifts

- **Interest Rates and P/E Ratios.** Since bond and equity markets are competitors in attracting capital from investors, one would expect that a rise in interest rates on bonds would trigger equity markets to price at lower price-to-earnings (P/E) ratios. However, the two are not perfect substitutions since the return potential and risk levels are quite different. Equity market P/Es have drifted higher over the years with falling rates, but perhaps not as much as their historical relationship would suggest. As a result, equity P/Es may be less likely to decline as rates begin to rise over the coming year.
- **Interest Rates and the Economy**. Rising rates should act to slow the economy, as the Federal Reserve seeks to tame excess inflation. However, the bond purchase tapering and rate hikes being implemented at the start of this tightening period are intended to bring the economy back to a more normal stable economic growth rate. For now, this tightening appears appropriate and unlikely to shove the economy into too quick of a slowdown. Eyes will be focused on the back half of the year when demand is expected to moderate and supply constraints may be abating.
- **Interest Rates and Equity Styles.** While the rise in rates at the start of this tightening cycle is unlikely to disrupt the broad market or economy, the rise in rates may trigger a shift within equity markets. Value stocks that trade at discounted valuations have until now been unable to sustain a significant run of outperformance relative to growth stocks. However, a sustained rise in short-term and longer-term interest rates could be the key to resolving this market conundrum.

Equity markets should prove resilient to initial Fed tightening, but relative performance of growth and value is likely to shift

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EARNINGS GOVERNMENT POLICY INVESTING INTEREST RATES MARKETS ECONOMY

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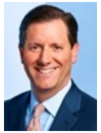

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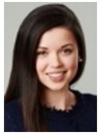

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