Fed rate hikes have arrived – what are the implications?

Tylar Lunke:

Hello everyone, and welcome to a real time update from RBC Wealth Management. We're recording this on Monday, March 21st, 2022. My name is Tylar Lunke and I lead the Managed Portfolio Strategies team. I'm joined today by two members of the Portfolio Advisory Group: Atul Bhatia, Fixed Income Portfolio Strategist, and Kelly Bogdanova, Co-chair of RBC's Global Portfolio Advisory Committee.

We just want to say thank you for joining us today and our goal over the next 10 minutes or so, is to provide some perspective on the Federal Reserve announcement of raising short-term rates for the first time since 2018. We're going to touch on what they said, including their plans for rates from here. What impact that has on the economy, as well as the equity markets and close with some thoughts around portfolio positioning. So with the table set a bit, let's jump right in. Atul, you are first up, so welcome to the recording. Just simply, what did we hear from the Fed this last week?

Atul Bhatia:

We heard a few things from them last week but the message that really matters, is that for now, the Fed is first, foremost, and almost exclusively an inflation fighting machine. That's important because the Fed has what's often called a dual mandate. They're supposed to set monetary policy to maximize employment, while keeping prices stable. What Fed chair Powell said in his press conference though, is that the labor market is so strong right now, that it's unhealthy for the overall economy. Unfilled job openings are a potential threat to sustainable long-term growth. With that view and with consumer prices rising at the fastest pace in 40 years, the Fed's mandate requires them to focus on fighting inflation. And that's what they clearly said they're going to do.

In policy terms, this translates to a high probability that each of the remaining six meetings this year, the Fed will raise overnight interest rate targets by a quarter percentage point, just as they did at last week's meeting. If that materializes, we should see overnight rates near 2% by the end of the year. Now the Fed always likes to keep flexibility and as the events of 2020 on have shown, life is unpredictable, so there's certainly no guarantee that rates will move in exactly that path. But we view the signal that Powell gave as one of the stronger Fed tightening communications. And we've adjusted our rate projections in line with his comments. One thing we didn't hear from the Fed last week, was how they plan on dealing with their bond holdings.

During the pandemic, the central bank bought Treasuries and other bonds to help bring down interest rates and stimulate the economy. They kept at it until recently and now they own roughly $9 trillion of securities. That's obviously a very large number, it's about a third of the

U.S. Economy's annual output. So how they reduce their holdings, is potentially important but it looks like we'll have to wait until the May meeting for details on that policy change.

Tylar Lunke:

Well, thank you for laying out their comments. That's certainly helpful. But as we turn over to the economy, what does this approach really mean for the economy?

Atul Bhatia:

Let's start with what it doesn't mean. We do not believe that the Fed's rate hike path means the U.S. Economy is inevitably headed for a recession. To begin with, while it's true that rates are moving higher, we're starting from such a low level, that even under the Fed's own projections, policy rates are still expected to be accommodative through at least 2023. The press can sometimes give the impression that the Fed has now become a headwind to growth, when what it's really doing, is reducing the degree of support it provides. One way to think about Fed policy is that they're continuing to add fuel to the economic fire, just at a slower pace. That's very different from dousing the flames with water.

In a broader sense, what the Fed's shift means for the overall economy, is that we're moving further into a transition. During the pandemic, the economy was heavily reliant on monetary support and government spending. The federal budget is now shrinking and the Fed has signaled that they are reducing and will eventually remove support as well. This is going to put the growth emphasis on consumers and corporations. And fortunately both of these sectors are in a fairly strong financial position. Corporate cash balances are high and households have seen large wage gains and they also accumulated significant savings during the pandemic. Inflation and supply chain issues are currently masking some of these strengths. But as those concerns recede, we expect both business spending and consumption to add to growth.

Now we have to acknowledge that risks are now higher. Inflation is forcing consumers to redirect spending away from discretionary items and supply chains remain a major problem for corporations. The conflict in Ukraine is likely to extend those issues, potentially through next year or even further out and more generally, investors and businesses are having to rethink their global exposure and geopolitical risk, which could lead to a slowing of business investment. Although those scenarios are all plausible, the economic data we look at does not yet indicate a high probability of recession this year. The current levels of economic growth, consumer spending and corporate earnings are consistent with slowing but positive growth and we continue to see that as the most likely economic outcome for 2022.

Investors should also keep in mind that policy makers can and likely would respond, if they saw an imminent recession. The Fed still has flexibility with its bond purchase program and could conceivably change its rate hike plans as well. For the federal government, there's an easy ability to ramp up spending and state and local governments are a potential third source of support, if required. Overall, we're keeping a close eye on economic developments but do not yet see the data to support a major change in outlook.

Tylar Lunke:

Thank you very much, Atul. Really appreciate your insight. Now over to Kelly. Welcome to the recording. Kelly, given the increase in rates with more to come as they've telegraphed, what potential impact do you see on the equity markets?

Kelly Bogdanova:

Tylar, there are a couple of distinctions to make. During previous rate hike cycles, in the over overwhelming majority of cases, if you look at the period right before the rate hike, the first rate hike occurred and right afterwards, the market historically was wobbly, meaning it tended to trade either sideways or down slightly. So the hesitancy and the volatility that we're seeing in the market right now is not unusual. Once the rate hike cycles got going though and more rate hikes occurred, the stock market's performance historically depended on how the economy actually held up, meaning whether or not a recession materialized. Our colleagues at RBC Global Asset Management, they conducted a study of performance of the S&P 500 surrounding Fed rate hike cycles that have occurred since 1954.

There were 17 of them. In 9 of the 17 cases, the economy kept growing and avoided a recession and the S&P 500 performed well. On average, it rose about 6%, six months after the first Fed rate hike. It was up 13%, one year later and 28%, two years later. So we had good and steady gains in those periods. But in 8 of the 17 Fed rate hike cycles, a recession occurred. And during these instances, the market's performance was below average. While the S&P 500 rose 8% in the initial six months and that performance was good, it was up only 7% one year later and 7% two years later on average. So in other words, when a recession happened, after a nice gain in the first six months after the first rate hike occurred, the market essentially treaded water.

It went nowhere as recession pressures mounted. Also, there was one outlier among the 17 rate hike cycles and this occurred when a strong blow from an outside force hit the economy. This was back in 1973, when the OPEC oil embargo triggered inflation, a severe recession and also caused a really difficult bear market and stocks fell sharply. Getting back to the current rate hike cycle that we're in, just like in previous periods, we think the stock market's performance will come down to whether or not the economy is able to avoid a recession. For now, our indicators suggest it will, as Atul mentioned. And if this turns out to be the case, the market should be able to regain its footing and deliver worthwhile gains over the next 12 months.

But there are more uncertainties about the economy than there were, say for example, at the beginning of the year and it's not just because of the Fed's rate hike cycle.

Tylar Lunke:

Okay. Well, thank you for walking through some of those indicators that we look at, as well as the historical context. And so, one of the big uncertainties in equities especially, is around the geopolitical risk that exists in the marketplace. So how does that play into your thinking?

Kelly Bogdanova:

Right now, market participants are definitely paying attention to the Russia-Ukraine conflict and the wider tensions between Russia and NATO. Also the strong sanctions by Western governments against Russia, which by the way, is the world's largest commodity producer and the agriculture and production constraints in Ukraine because of the crisis there. These are getting attention as well. Our concern here is that sanctions constrain global supply chains and this is already happening in Europe. The evidence is clear and these sanctions act as an indirect tax on commodity prices, which filters into the prices of multiple goods and services. And if you think about it, sanctions on commodities can have a boomerang effect. They absolutely inflict pain on the country that's being sanctioned but they can also impact countries that are doing the sanctioning.

And while we think that this boomerang effect will be strongest on Europe, the sanctions could pose some challenges for segments of the U.S. economy as well, albeit to a lesser degree than Europe. We've already seen gasoline prices rise here, for example. At a minimum, we think the sanctions widen the potential outcomes for U.S. economic and corporate earnings this year. And they'll make it more challenging for central banks to strike a balance between fighting inflation and protecting economic growth. Because U.S. recession risks are currently low by our indicators, we don't think the geopolitical risks and the knock-on effects from sanctions or even the start of the Fed's rate hike cycle, call for making major changes to U.S. portfolio positioning right now.

But we do think that risks have risen compared to the beginning of the year and that this is something we'll be monitoring closely in the coming weeks and months. So for investors at a minimum, this is a good time to check portfolios, to make sure that you're comfortable with the level of equity exposure that you have. And we also think it's prudent for portfolios to include stocks in defensive sectors and those are sectors that are less dependent on economic growth and are more resilient to inflation. And this would include stocks of companies that have the potential to grow dividends year after year.

Tylar Lunke:

Well thank you, Kelly, for the perspective around watching your portfolios, taking a look at equity and the positioning among the sectors. Thank you to Atul as well for joining the recording. We just want to make sure everybody is aware that we do continue to send out real time updates and special reports, especially during periods of higher volatility like we've seen. So check out the recording player for links to explore. Also keep an eye out for additional articles published within the Global Insight suite, as well as those from across RBC. And as a reminder, we do want to make sure that if you have questions about your investments, we would encourage you to stay in touch with your RBC financial advisor. Thank you all for the time today. Take care and have a great day.

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