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The interest rate turnaround

Market Comment, April 2022

Since the start of the year, there have been clear signs from the world's major central banks that they intend to embark on a marked, albeit gradual change in monetary policy. The interest rate turnaround is upon us, with the stimulus provided for global growth and the financial markets being ramped down. Interest rate hikes and the reduction in bond purchases by the central banks are leading to an increase in the cost of money and a decline in the monetary liquidity available to the financial markets and the global economy. This often means an increase in market volatility.

In March, the US Federal Reserve (Fed) heralded the interest rate turnaround by increasing key rates by 0.25% in line with market expectations. The Fed had already announced at an early stage that a decision on an "orderly" reduction of its balance sheet would come later. It is thus signalling that it will switch to a more restrictive monetary policy at the end of its bond purchases.

As recently as December, the market had only priced in around three interest rate hikes for 2022. Following the Fed meeting in March, however, the Fed members themselves now expect between seven and eight. In justifying its change in stance, Fed Chair Jerome Powell pointed to the fact that inflation is trending higher than the Fed and market consensus. Both US headline inflation, which is being driven by high energy prices, and so-called core inflation, which does not include food and energy prices, are now clearly above average by historical standards. The driver of core inflation, which is higher in the US than in the Eurozone, is wage growth that has come about due to the much more marked decline in the unemployment rate in the US than in other countries. In addition, as is the case in other countries, there are supply bottlenecks in various sectors as well as more expensive component and transport prices and high raw material prices in virtually all areas.

A certain level of political motivation can also not be ruled out in connection with this change of monetary policy. The considerable rise in inflation in the US is not only weighing on consumer sentiment, but could also jeopardise the election chances of the Democratic Party of US President Joseph Biden. Although President Biden recently confirmed Fed Chair Powell in office, he fears that his Democratic Party could lose its majority in the US Congress in the mid-term elections if inflation remains high.

"With yields still historically low, we are currently underweight bonds."

Gérard Piasko, Chief Investment Officer

The less expansive approach of the European Central Bank (ECB), as signalled in February by ECB President Christine Lagarde, also appears important for the financial markets. She repeatedly expressed her concerns about the marked increase in inflation in the Eurozone and no longer ruled out the prospect of a first interest rate adjustment this year. The markets therefore also began to price in initial interest rate hikes in the Eurozone, with this being true for both the bond and equity markets and the currency markets. As has already been noted on several occasions, increased fluctuations in both directions are thus to be expected for the euro against the US dollar and the Swiss franc.

It is interesting to see how the equity markets have behaved in the past in response to interest rate hikes: A total of eight Fed interest rate hike cycles can be seen over the past 40 years. In each case, the equity markets were more volatile and less positive a few months after the initial interest rate adjustment than was the case a few quarters later. The US S&P 500 equity index, for example, only posted a positive performance in the three months after the initial interest rate adjustment in half of the eight cycles. After 12 months, however, it was in positive territory in 70% to 80% of the cases. As always, it has to be emphasised that past performance or historical experience in no way implies that this will also be the case in future. There are, of course, many other factors that play at least as important a role as the interest rate hikes themselves. For example, the business performance of companies is also significant, a factor that is greatly influenced by the general business cycle and the companies' valuation – especially important when interest rates increase – as well as by their level of debt and pricing power during times of elevated costs and higher inflation. This means that greater attention should be paid to securities selection within the equity markets, as the positioning of individual companies is now very important, especially in comparison to competitors in the same sector.

There are thus two conclusions at the present time: Firstly, it is quite conceivable that equities could outperform bonds over the entire interest rate hike cycle, with demand from the central banks waning. And secondly, ensuring a focus on quality when selecting individual securities is this time likely to become at least as important as in the past.

Gérard Piasko

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