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Markets need not fear the first Fed rate hike

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- **First raise since 2006 may come in the third quarter**
- **Data shows stocks and bonds aren't always hurt**
- **Any hike would reflect a strengthening US economy**

Markets need not fear the prospect of the first rate hike in almost a decade, says Robeco's CIO Investment Solutions, Lukas Daalder.

The US Federal Reserve (Fed) last month outlined the criteria for the first rise in the key US borrowing rate since 2006, leading many investors to expect it in the third quarter. It follows increasingly positive signs that the world's largest economy is growing while inflation remains benign.

In theory a rate hike is bad for stocks, as it raises the borrowing costs of companies while reducing the spending power of consumers. It's also theoretically bad for bond returns, as bond yields would rise and bond prices, which move inversely to yields, would fall.

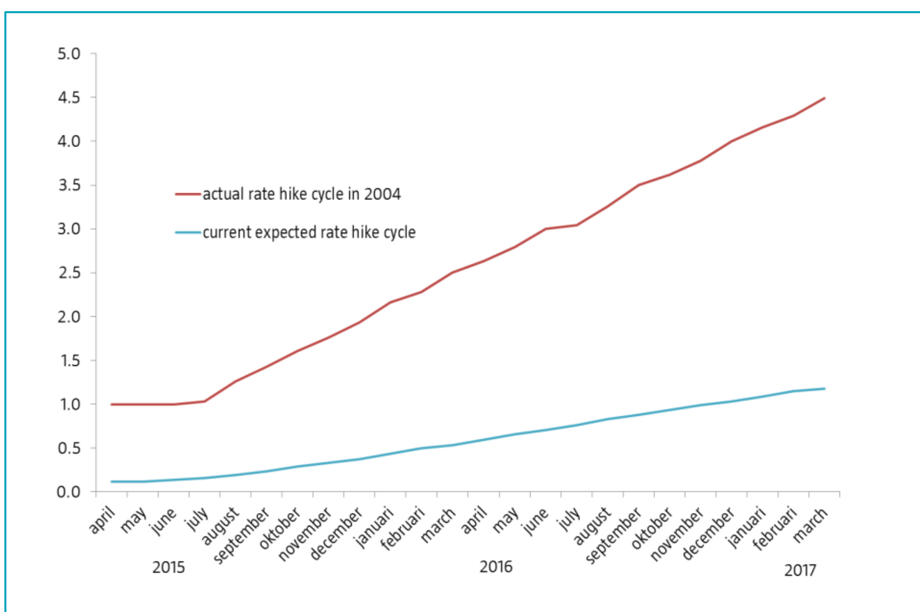
Some strategists subsequently expect the immediate end of equity and bond bull market rallies that have produced strong returns for years. However it doesn't necessarily have to be that way, says Daalder.

No need to panic

"If you had expected the markets to panic on the news that the Fed was on the verge of raising its official target rate for the first time in over nine years, you would have been mistaken," he says.

"Strong growth figures, a strengthening labor market or higher inflation will trigger an earlier rate hike, and could therefore be seen as negative news for financial markets moving forward. But should it be seen like this? Is a rate hike indeed such a bad thing for financial markets?"

'Stocks wobbled at first before returning to normal'



The expected moderate rate hike path. Source: Bloomberg, Robeco

Daalder says investors should answer the question by looking at the rationale behind a rate hike, and then analyzing data to see what happened in the past. Data going back to the 1970s and 1980s shows that stocks wobbled at first before returning to normal, while government bond yields did not rise as expected, and the impact on the credit market was negligible.

Is a rate hike negative news?

"In theory, higher interest rates have the effect of slowing an economy down," he says. "Consumers would save more and spend less. Companies could be forced to scrap investment projects and reduce debt, while governments could be faced with higher financing costs, triggering spending cuts."

"Stocks could be hit by a lower earnings outlook; corporate bonds could feel the pain from potentially higher defaults, and commodities may decline due to lower end-demand. Higher rates can lead to higher bond yields and therefore initially lower returns," Daalder says.

"So much for theory though… the real world can turn out to be a bit more complicated than that. For one, rates are not raised without a reason. Normally, higher rates are a sign of a positive economic environment, meaning strong demand, an improving earnings outlook, and overall positive sentiment."

"And so given that sentiment is an important driving force for financial markets, a rate hike does not necessarily have to be seen as all that negative. Much will depend on the circumstances that surround the rate hike and the expectations moving forward."

'Much will depend on the circumstances that surround the rate hike'

Results from the past

Daalder says data for the major markets of the US, Germany, Japan and the UK do not bear out the theory that a rate hike must be bad. His team's research identified 29 rate hike cycles since 1971 and then specifically looked at what happened to asset prices in the period of 90 days prior to the first rate hike and the 200 days that followed.

- Stocks on average fell for the first two months into the rate hike cycle, only to resume their uptrend after that. Rate hike cycles in the 1970s were a lot more damaging than those in later periods, particularly those aimed at reducing inflation that came from supply side shocks. However, excluding the Eurozone crisis, when stocks fell 30% following a rate rise in 2011, the average equity market performance in the 200 days following the first rate hike in the 1980s until now has amounted to 5%. This seems to suggest that rate hikes are not all that damaging for equity performance.

- Bonds returns were more mixed, though the data set is more limited, using daily data for 10-year US bonds going back to 1971, but later period for Germany (1989), Japan (1987) and the UK (1989). While on average, yields did rise in the period following the first rate hike, there is a wide variety in performance across regions. There was no clear conclusion for the UK and Germany, while rate hikes in Japan normally pushed yields down rather than up. Interestingly, the one most important exception to this pattern was the US, where yields generally did rise in the 200 days following the first rate hike.

- Credits data is more limited, only going back to 1986, using the yields of US corporate bonds rated BAA by Moody's. At first sight, credit yields did rise prior to and up until 60 days after the first rate hike over six rate cycles. However, the overall level of the move was hardly worth mentioning, with an average yield rise totaling 40 basis points. Given that yields over the full sample range averaged 7.7%, and the change in underlying US Treasuries during that same timespan totaled 55 basis points, it means that spreads actually declined during that period

'Monetary policy is far more predictable than it was in the past'

Daalder says there are three other things to bear in mind concerning rate hikes: what expectation has already been priced in; the happy scenario that central banks now flag everything in advance; and the fact that no two rate rises are ever the same.

"Simply put, as long as the rate hike is in line with the movement that is priced into the forward curve, the impact in longer-dated bonds should be minimal," he says.
"The fact that the Fed these days is even flagging that it will stop using a word in a press release, so as not to upset the markets too much, clearly indicates that monetary policy is far more predictable than it was in the past, when Volcker or Greenspan were still conducting monetary policy."

"And no rate hike is ever the same. Hiking rates from a level of 5% in reaction to an unexpected spike in inflation is something completely different from a 25 basis point rate hike from the current depressed level of rates. Focusing too much on interest rates may therefore turn out to be a wrong thing to do: the future development of the bonds position of the Fed may well be a much more dominant factor to keep an eye on."

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