BEHAVIOUR OF EQUITY AND BOND MARKETS IN TIGHTENING CYCLES

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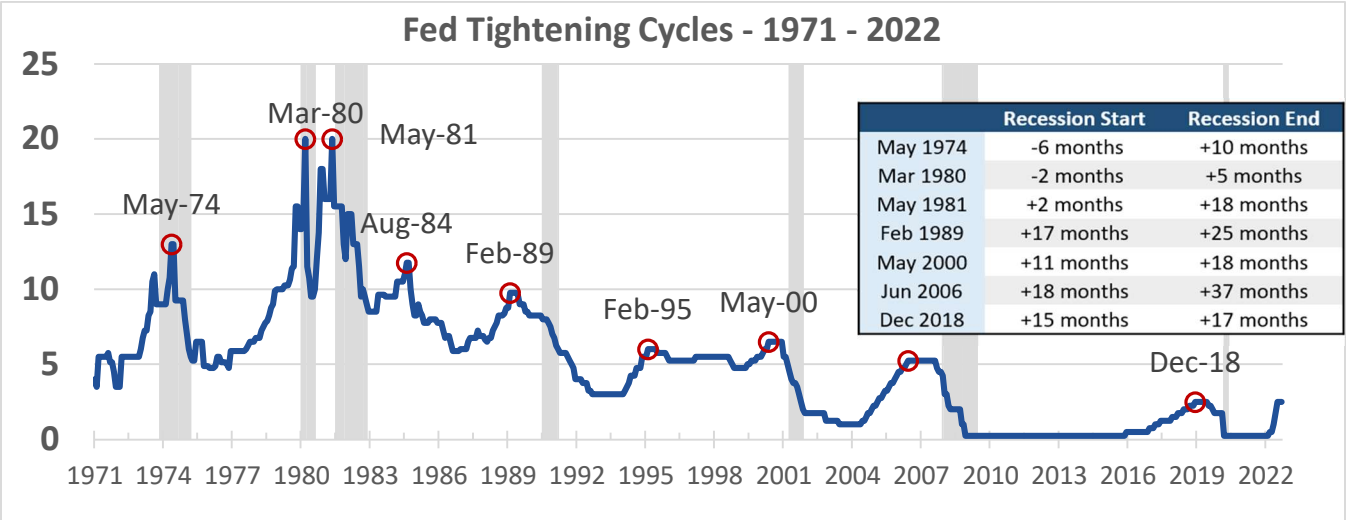
In this brief report we look back at the last nine Fed tightening cycles since 1970 (Chart 1) to see how bond and equity markets in the U.S behaved in the 12 months prior to and 12 months following the peaking of policy rates, the red circles indicate the dates when policy rates reached the peak in that tightening cycle. While 9 periods is hardly enough data to make statistically significant predictions, it can help serve as a guide to the range of outcome financial markets may experience during periods of monetary tightening. Specifically, we examine the U.S benchmark 10-yearTreasury yields before and after the Fed policy rate reaches its peak (t=0), and a provide a similar analysis of equities using the S&P 500 Index.

9 tightening cycles, 7 of which are followed by recessions

As shown in the table on Chart 1, tightening cycles have historically been followed by recessions. The rates did not reach peak until the economy was already in recession in 1974 and 1980, and in subsequent cycles there were lead time of 2 to 18 months between rates peaking and the economy slipping into recession. There were only two tightening cycles which were not followed by recessions.

Chart 1



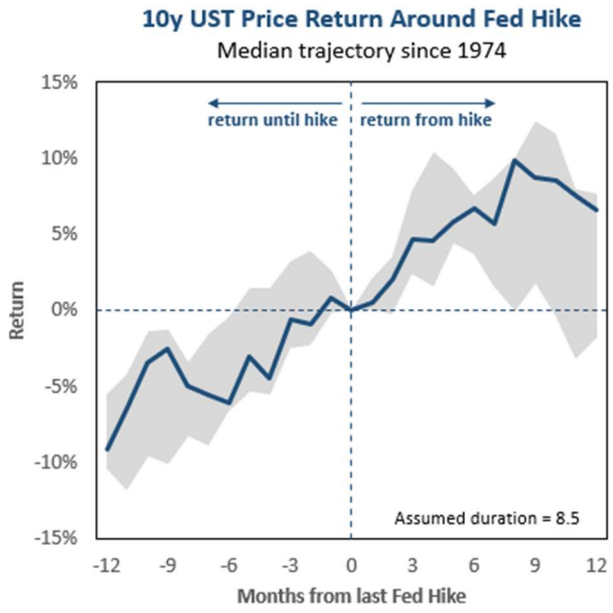
	Recession Start	Recession End
May 1974	-6 months	+10 months
Mar 1980	-2 months	+5 months
May 1981	+2 months	+18 months
Feb 1989	+17 months	+25 months
May 2000	+11 months	+18 months
Jun 2006	+18 months	+37 months
Dec 2018	+15 months	+17 months

Bloomberg: data as of October 2022

Bonds tend to sell off until peak, then typically rally after peak

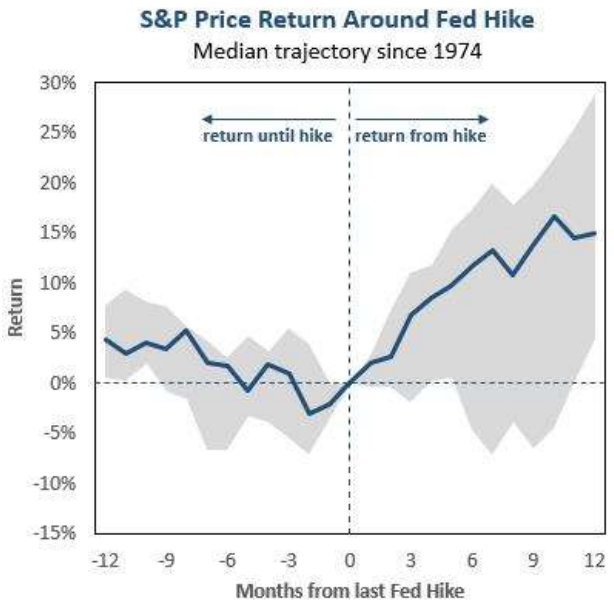
Looking at the 10-year U.S Treasury market, we observed that bonds tend to exhibit negative price return as yields rise in the period leading up to the final rate hike (t=0). The analysis showed that, using median values, the 10-year U.S Treasury yield tends to peak 1 month before the last rate hike of the tightening cycle. This was followed by a decline in yields immediately after the policy rate reaches peak, resulting in a positive price return.

Chart 2



Shaded area indicates the returns range of 25-75th percentile
Bloomberg: data as of October 2022

Chart 3



Shaded area indicates the returns range of 25-75th percentile

Equities also tend to rally after peak in Fed rate…

As shown on Chart 3, equities tend to be volatile and returns were generally negative when rates are rising, while median returns of equities were remarkably positive in the months following the last rate hike. However, as noted by the shaded area in Chart 3, the range of outcomes can be extremely wide in the months following the rate reaches its peak.

…except during recessionary periods

A key indicator for the return's trajectory is whether the economy is in recession or not. Equity returns tend to be negative if the economy is in a recession, and returns are more likely to be positive if the economy is not in a recession. As highlighted in the table below, out of the 27 periods of returns in our data sample, 8 of those periods were amidst recessions and 19 of which were not recessionary periods. Notably, equity markets had positive returns in 17 out of 19 of the non-recessionary periods. However, in 6 out of those 8 recessionary periods, equity returns were in negative territory.

				SPY Change (%)			
Date	Fed Rate	Inflation	Unemp.	3m before	3m after	6m after	12m after
May 1974	13.00	6.8	5.1	10.2%	-17.3%	-19.8%	4.4%
Mar 1980	20.00	12.5	6.3	5.7%	11.9%	22.9%	33.2%
May 1981	20.00	9.5	7.2	-1.0%	-7.4%	-4.7%	-15.6%
Aug 1984	11.75	5.1	7.5	-9.7%	-1.9%	8.7%	13.2%
Feb 1989	9.75	4.8	5.2	-5.2%	11.0%	21.7%	14.9%
Feb 1995	6.00	3	5.4	-6.9%	9.4%	15.3%	31.4%
May 2000	6.50	2.4	4	-3.8%	6.8%	-7.4%	-11.6%
Jun 2006	5.25	2.6	4.6	1.9%	5.2%	11.7%	18.4%
Dec 2018	2.50	2.2	3.9	16.2%	13.1%	17.3%	28.9%
Median	**9.75**	**4.8**	**5.2**	**-1.0%**	**6.8%**	**11.7%**	**14.9%**
Average	**10.53**	**5.4**	**5.5**	**0.8%**	**3.4%**	**7.3%**	**13.0%**
SD	**5.93**	**3.4**	**1.2**	**8.1%**	**9.7%**	**13.9%**	**16.8%**
Positive periods				**4**	**6**	**6**	**7**
Negative periods				**5**	**3**	**3**	**2**

Recession

Bloomberg: Data as of October 2022

1980 and 1981 cycles were the exceptions

While the historical data set and median data provide a good base for expectations, we caution about drawing conclusions, as we observed a wide range of outcomes in the data set. On the fixed income side, over the nine tightening cycles, the bond price return was almost equally split between the number of periods with positive and negative performance in the 3-month window leading to the final hike of the cycle. For example, in August 1984 when the policy rate peaked, the price return on the benchmark Treasury yield was positive, as yields declined by 103 bps. This contrasts with March 1980, where we observed the 10-year yield rising rapidly in the 3-month period leading up to the peak rate hike. During this period, the Fed rate peaked at 20% and inflation stood at 12%. The Fed later cut rates by 5.5% later in the year in response to the unemployment rate climbing above 6%. This proved to be only a brief reprieve from monetary tightening. With inflation accelerating yet again, the Fed pivoted back to rate hikes later in 1980 even as the unemployment rate continued to increase.

This pivot by the Fed in 1980—which can be considered a policy error in retrospect—has skewed the results of this analysis. Excluding this period as an outlier event, on average, price performance of equities and bonds tend to improve after the last rate hike. On average, the S&P 500 was 7.5% higher 3 months after the final rate hike, and 15.8% higher twelve months later.

Investment Implications

Our historical analysis can act as guide for navigating the current environment and offer some insight. Based on current market pricing as implied by the futures market, the Fed policy rate is expected to reach a peak sometime between March and May of 2023. As observed in past tightening cycles, we are currently going through a period of re-pricing in markets where asset values are weighted by rising rates and negative investment sentiment. In the meantime, the selloff during the tightening period leads to discounted values across asset classes, reducing risk to the downside and provides a great entry point ahead of a period of potentially above average price return for the patient investor.