Markets in a Minute
Inflation Part 2: How Will the Fed's Interest Rate Hikes Affect Equity Markets?

Investors and policymakers hoping for signs that inflation is cooling were undoubtedly disappointed the week of February 7th. The latest Consumer Price Index (CPI) release showed that inflation is not only picking up speed — climbing to a 40-year high of 7.5% in January — but spreading beyond corners of the economy hit hardest by the pandemic.

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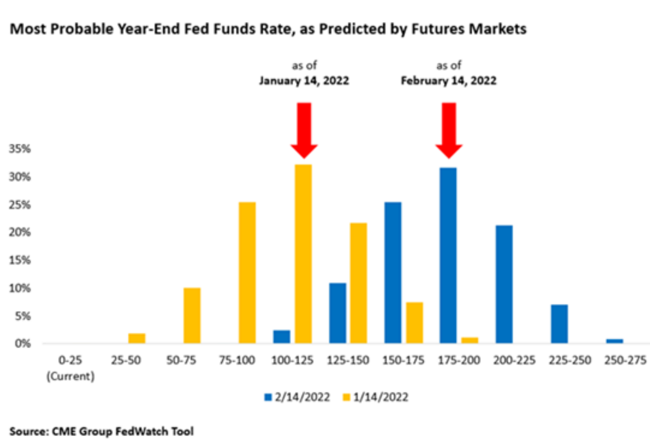
- Following the 2/7/22 CPI release, James Bullard, president of the Federal Reserve Bank of St. Louis, told Bloomberg News that he has become "dramatically" more hawkish and supports raising interest rates by a full percentage point by the start of July.
- Market expectations for rate increases have shifted dramatically since the start of the year.
- In mid-January, investors assigned a less than 5% probability to a cumulative rate hike of 175 basis points (1.75%) by year's end. As of yesterday, investors were pricing in a roughly 30% chance of an increase of that magnitude by mid-December, according to the CME Group's FedWatch Tool.



- The possibility of a more-aggressive Fed response pushed the yield on the two-year Treasury — which typically tracks short-term rate expectations — up by more than 21 basis points to nearly 1.6% on Thursday, 2/10. That marked its biggest one-day jump in yield since 2009.

What does all this mean for U. S. stocks?

- Research shows that risk assets can continue to do well even when the Fed is hiking rates, but the ride is likely to be choppy.
- Since 1964, on average the S&P 500 has tended to rise in the six months before a Fed rate hike and in the three months following, according to an analysis by Renaissance Macro Research.
- The same analysis shows that market volatility (as measured by the VIX Index) has tended to rise in the months leading up to a Fed rate hike. This year, we've already seen sharp price moves and rotations in equities.
- A recent Barclays analysis found that during the last four rate-hiking cycles, equity markets generally performed well in the months before the first bump in rates. Equities typically saw a "mild, short-lived sell-off" in the first couple months following initial rate hikes, but then resumed their upward trajectory as the Fed continued to tighten.

As the recovery has unfolded, the Fed has been careful (some might say too careful) to wait until the U.S. economy is on firm footing before pumping the monetary policy brakes.

In fact, even as prices and COVID-19 cases soared in January, the economy created far more jobs than expected. Wage gains also accelerated, and the labor pool expanded.

So far, S&P 500 corporate earnings for the fourth quarter have been strong, with most reporting companies (77%) beating estimates. Corporate profit margins increased by more than 20% in the third quarter on a year-over-year basis.

We think equities still have room to run, but market dynamics are likely to shift as the recovery matures. Until now, investors have tended to favor the riskiest areas of the market. But as we move into a new phase of the market cycle, we expect quality stocks (i.e., those with reliable growth models and strong balance sheets) to outperform. At this inflection point, it may not only make sense to favor quality, but for investors to make sure their risk profile is aligned with their tolerance.

(see next page for important disclosures)

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