SPOTLIGHT | DECEMBER 2021

INVESTING AMIDST THE INFLECTION IN THE FED POLICY CYCLE

Key points

- The surge in inflation in 2021 combined with the sharp fall in unemployment leaves two of the US Federal Reserve's key policy objectives within reach as the year comes to a close.
- Moreover, with US housing prices rising at a pace seen only three times since the early-1980s, the Fed must likewise keep its financial system stability objectives in mind consistent with the start of a Fed policy tightening regime that markets are increasingly expecting in 2022.
- Looking back to the nine policy tightening cycles the Fed has undertaken since the early-1970s, bond investors face a challenging road ahead with rising short and long-dated Treasury yields characterising almost all of these periods.
- Surprisingly, equity investors have fared better, at least in nominal terms as seven of the nine policy tightening regimes have seen the S&P 500 deliver positive returns driven almost exclusively by earnings growth.
- Investors should be cautious about the pace of Fed tightening being priced in by markets. Even given the announcement of an accelerated end to bond purchases and an expected two 25 bps rate increases in 2022, the tightening in financial conditions may be more dramatic than that seen in 2013–15 and bring increased volatility, consistent with the mini-cycle within the economic cycle.
- As a result, we see increasing opportunities in alternative strategies including long-short and relative value credit strategies and, in equities, high alpha and long-short equity strategies to both manage risk while at the same time seeking positive inflation adjusted returns looking ahead.

Global Investment Committee

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Fed policy objectives nearly achieved…

Though anxiety is building given the near historically high rates of inflation being seen in the US economy in 2021, in the context of the Federal Reserve's 'average inflation targeting' framework adopted in August, 2020, the US economy is only now reaching the average 2% target over the five-to-eight-year horizon that Fed governors have outlined as the timeline for assessment.

While many have raised the fear of 'stagflation', economic stagnation combined with high inflation as seen in the 1970s, the US job market suggests something else.

With the headline unemployment rate having fallen to 4.2%, unemployment has only been lower in the boom of the 1960s, at the height of the tech bubble in early-2000, and prior to the pandemic, in 2018-19 following the Trump tax cuts of 2017.

Just as telling, the number of permanent job losses during the 2020 recession have already fallen back to levels seen in 2005-06. Typically, it takes permanent job losses during recessions at least 24-36 months to return to pre-recession levels.

Though these two policy objectives appear within reach, a more unspoken policy objective, especially as a result of the 2008-09 Global Financial Crisis, of ensuring financial system stability could be challenged should the Fed not begin to address the growing pressures in the US housing market.

According to the US Census Bureau, median single family home prices rose nearly 18% in October from the previous year. While undoubtedly, the global pandemic has skewed some of the year-on-year comparisons, even using two-year compound annual growth rates to smooth out the effects of the pandemic, prices are rising at a 13% annualised pace according to both the Census Bureau as well as the CoreLogic Case Shiller data series.

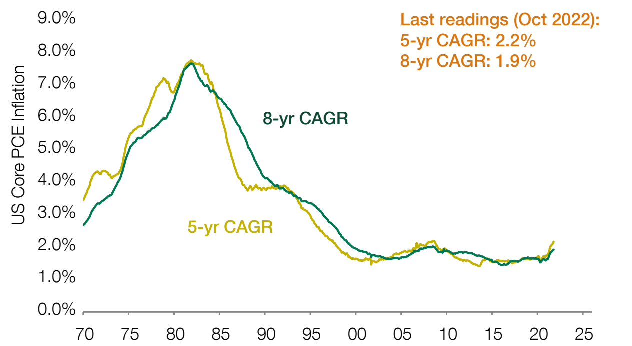
Looking back to the early 1980s, US housing prices have only risen at this two-year pace, three times before, in 1987, 2004-05 and in 2013. Policy tightening that ensued shortly after the 1987 and 2004-05 episodes, helped trigger the US Savings & Loan Crisis through 1995 and first the sub-prime and then the Global Financial Crisis in 2007-09.

Even following the 2013 surge in property prices, it can be argued that the subsequent Fed tightening helped trigger the rising defaults in the US energy high yield market in 2015-16. However, in this instance, housing price growth slowed in a more orderly fashion, back towards 5% per annum in 2015-19 – a comparative soft landing.

So, having achieved its inflation target and being close to achieving its full employment objectives and with a growing risk of medium-term financial system instability, a pivot in Fed policy is understandable in light of the shifting balance of risks.

Indeed, financial markets have now moved from pricing in the first interest rate hike for 2023 as recently as September, to now pricing in an end to the Fed's bond purchases as soon as March, 2022 combined with two or even as many as three Fed rate hikes in the year to come.

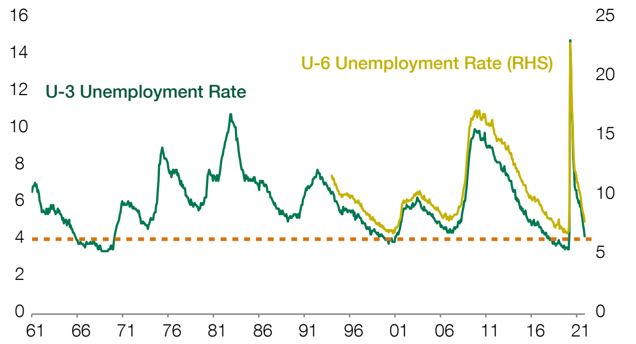
The Fed's new 'average inflation targeting objectives' have been achieved with the 2021 inflation surge



Sources: Bureau of Labor Statistics, Bloomberg Finance L.P. and UBP

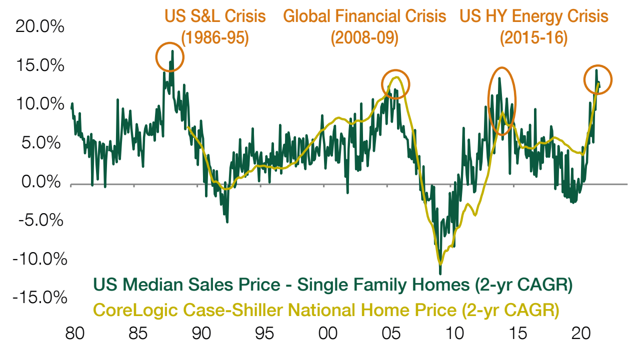
*Five-to-eight-year time horizons based on comments from Atlanta, Cleveland, St. Louis and Chicago Fed Presidents following the Fed's pivot to Average Inflation Targeting

The Fed's full employment mandate appears increasingly in sight with the unemployment rate challenging 4%



Sources: Bureau of Labor Statistics, Bloomberg Finance L.P. and UBP

US home prices rising at a pace consistent with that seen ahead of the US S&L Crisis and the Global Financial Crisis



Sources: Census Bureau, CoreLogic Case-Shiller, Bloomberg Finance L.P. and UBP

Looking back at historical Fed tightening cycles

While much debate still exists about the pace of the tightening cycle that lies ahead, there is broad agreement that the accommodative stance of Fed policy enacted as a result of the global pandemic is now at an end and a pivot towards a normalisation of policy is set to take place in 2022.

Looking back to the 1970s, investors can draw important lessons from the nine tightening cycles embarked upon by the Fed over the past 50 years.

Fed policy cycles have typically lasted 1-2 years and involved 200-400 bps in rate hikes

Fed Policy Cycle	Term (Mos)	Chg In Fed Funds	Beg. Real** Fed Funds	End Real** Fed Funds
’72-‘74*	27.4	950	(0.7%)	8.3%
’76-‘80*	40.6	1,525	(1.9%)	9.5%
’83-‘84	16.3	325	2.5%	7.1%
’87-‘89	23.3	375	2.1%	5.3%
’94-‘95	13.1	300	(0.3%)	3.1%
’99-‘00	17.3	175	2.5%	4.2%
’04-‘06	28.4	425	(0.4%)	3.1%
’14-‘16***	21.3	351	(4.7%)	(1.4%)
’17-‘18***	22.4	214	(1.8%)	0.4%
Ave.	**23.3**	**516**	**(0.3%)**	**4.4%**
ex-70s	**20.3**	**309**	**0.0%**	**3.1%**

Sources: Federal Reserve Bank of Atlanta, University of Chicago, Bloomberg Finance L.P. and UBP * Fed Funds was not the policy target rate in the 1970s **Fed Funds less 12-month trailing average CPI ***using the Wu-Xia Shadow Federal Funds Rate to incorporate the impact of QE

Tightening cycles result in rising yields, flattening yield curves and more recently wider spreads

Fed Policy Cycle	Term (Mos)	Chg in US 2-yr Yield	Chg in US 10-yr Yield	Chg in Baa less 10-yr
’72-‘74	27.4	NA	148.0	(66.0)
’76-‘80	40.6	921.9	563.0	(41.0)
’83-‘84	16.3	313.3	249.9	(115.9)
’87-‘89	23.3	286.7	175.8	(75.8)
’94-‘95	13.1	264.0	155.9	(35.9)
’99-‘00	17.3	50.1	12.9	49.1
’04-‘06	28.4	350.9	116.5	(65.5)
’14-‘16	21.3	40.1	(74.1)	132.1
’17-‘18	22.4	122.8	29.4	19.6
Ave.	**23.3**	**293.7**	**153.0**	**(22.1)**
ex-70s	**20.3**	**264.0**	**95.2**	**(13.2)**

Sources: Bloomberg Finance L.P. and UBP

Though the 1970s were unique in many ways, amongst the most distinctive aspects of policy setting during that period was that the Fed Funds rate was not used as the policy target. As a result, the two 1970s tightening cycles saw the Fed Funds rate rise by a remarkable 1,000-1,500 bps!

As the Federal Open Market Committee began to use the Fed Funds rate as its policy rate in the 1980s, tightening cycles have been relatively consistent, lasting from 12-28 months and resulting in rate hikes totalling 200-400 bps.

Taking inflation into account, outside of the 1970s and early-1980s, the real Fed Funds rate has typically risen by 300 bps with the Fed usually ending its tightening cycle at a zero or positive inflation adjusted Fed Funds rate.

With the exception of the 1980s and 1999-2000, tightening cycles have begun at a negative inflation adjusted Fed Funds rate. Since the Global Financial Crisis, tightening cycles have started from deeply negative inflation-adjusted Fed Funds levels.

The implications for bond investors have been largely consistent over the past 50 years. Fed tightening cycles kick off a flattening in the US yield curve, with short-term rates rising faster than long-term yields.

Consequently, a Fed tightening landscape should prove challenging for fixed income investors in the months ahead with the potential for rising rates and widening spreads resulting in the prospect for ‘coupon-minus’ returns as traditional fixed income investors experienced in 2021.

While credit investors saw some reprieve on average, since 1999, investment grade spreads have typically widened as the Fed withdraws policy support from the US economy.

Equity investors, on the other hand, fare comparatively well versus their fixed income counterparts. As tightening cycles typically accompany robust economic activity, tightening cycles have seen periods of strong earnings growth driving admittedly modest equity returns going back to the 1970s.

During the nine Fed tightening episodes, S&P 500 investors have seen flat or positive returns in seven of the episodes. Indeed, the two negative returns both came pre-1990.

All four of the pre-1990 tightening cycles saw rising, inflation adjusted 10-year yields of more than 100 bps translating into multiplate compression of as much as 30-40% in the 1970s and 1980s.

Fortunately, earnings growth in those four periods ranged from 22% to 55% offsetting the vast majority of the headwinds to returns posed by contracting PE ratios, generating break-even S&P 500 returns outside of the 1972-74 tightening cycle.

Since 1990, inflation adjusted US 10-year yields have tended to rise more modestly during tightening cycles resulting in PE compression of 1-20% with the 1999-000 period seeing modest PE expansion.

As a result, the more modest earnings growth seen during tightening cycles has been more than enough to offset the PE compression and deliver, on average, 6% returns during tightening cycles from 1990-2018, consistent with the modest returns we expect in the current mini-cycle.

Since 1990, tightening cycles have still delivered positive earnings growth driven equity returns

Fed Policy Cycle	Term (Mos)	Chg In S&P 500	Chg in PE Ratio	Chg in EPS
’72-‘74	27.4	(18.1%)	(43.4%)	44.6%
’76-‘80	40.6	0.0%	(35.1)%	54.1%
’83-‘84	16.3	1.4%	(10.7%)	22.0%
’87-‘89	23.3	(1.0%)	(36.2%)	55.2%
’94-‘95	13.1	1.2%	(13.0%)	16.3%

Fed Policy Cycle	Term (Mos)	Chg In S&P 500	Chg in PE Ratio	Chg in EPS
’99-‘00	17.3	9.8%	2.9%	6.7%
’04-‘06	28.4	10.9%	(19.4%)	37.6%
’14-‘16	21.3	0.5%	(0.5%)	1.0%
’17-‘18	22.4	6.1%	(15.5%)	25.5%
’72-‘89	23.3	(4.4%)	(31.3%)	44.0%
’90-‘18	20.3	5.7%	(9.1%)	17.4%

Sources: Standard & Poor’s, Bloomberg Finance L.P. and UBP

Watch for rising risks of policy error ahead

While tightening cycles had a moderating impact on S&P 500 returns in the past, risks exist that an accelerated tightening timeline may result in a more significant tightening in financial conditions than the gradual steps taken in the sequential tightening process – communication, then tapering followed by rate hikes after a delay – in 2013-15.

Indeed, even as the Fed pivoted from completing its tapering in October, 2014 to its first rate hike in December, 2015, tightening financial conditions likely contributed to a devaluation of the Chinese Yuan in August, 2015 and the surge in defaults, especially among US energy high yield companies, as Saudi Arabia began a price war with other OPEC+ producers.

With markets currently pricing in limited time between the end of tapering, expected now in March, 2022 and the Fed’s first interest rate hike for the cycle in June, the risk exists that a more dramatic tightening in financial conditions may emerge should increasingly hawkish consensus expectations come to pass in the months ahead.

Admittedly, unlike in 2015, China looks set to ease policy pre-emptively looking forward to avoid the hard landing seen in 2014-15.

Similarly, with fiscal policy sidelined in 2015-16, there is the prospect of US President Biden’s Build Back Better social spending legislation passing to offset the monetary tightening ahead. Indeed, the 2017 Trump tax cuts served a similar role in balancing the impact of the Fed tightening cycle at the time.

Investing amidst an inflection in Fed policy

With the start of a Fed tapering and rate hike cycle combined with uncertainty around the newest pandemic variant as we enter 2022, based on historical patterns, the direction for fixed income looks increasingly challenged around delivering attractive risk-reward profiles looking into next year.

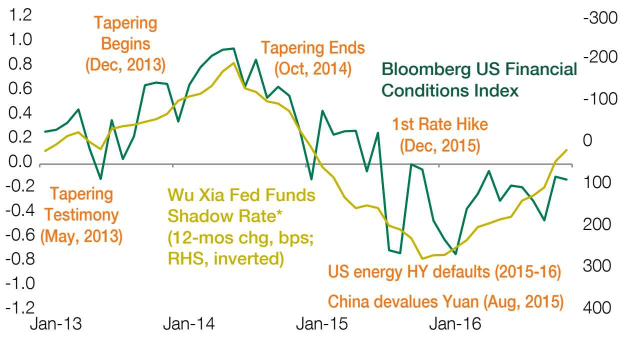
Taking into account the fact that the bulk of the traditional fixed income landscape also fails to deliver above inflation rates of return, investors will need to look increasingly to alternative income strategies both to secure positive inflation-adjusted returns as well as to protect against the prospect of rising interest rate and credit spread volatility during this policy inflection ahead.

Indeed, we see opportunities in alternative strategies including long-short credit and other relative value fixed income strategies. Moreover, private market opportunities including trade receivables, consumer loans, life insurance, and real estate offer potential to capture illiquidity premia to help overcome the higher inflation barrier ahead.

In addition, with volatility set to rise in the future, volatility capturing structured products offer investors tactical opportunities to navigate this challenging environment.

In equities, with modest returns expected amidst policy tightening, active, high alpha strategies including long short equities in the alternatives space should help both to manage risk while at the same time seeking positive inflation adjusted returns looking ahead.

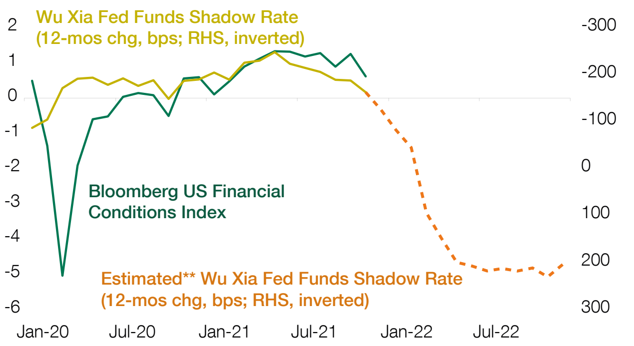
The gentle tightening timeline of 2013-15 led to a gradual tightening in financial conditions



Sources: Federal Reserve Bank of Atlanta, Bloomberg Finance L.P. and UBP

*Wu-Xia Fed Funds Shadow Rate incorporates the impact of QE into the Federal Funds Target rate framework of the Federal Open Market Committee

An aggressive tightening timeline could result in a sharp, unwanted tightening in financial conditions



Sources: Federal Reserve Bank of Atlanta, Bloomberg Finance L.P. and UBP

** assuming Wu-Xia rate reached zero before 1st rate hike, assumed in June, 2022 with a 2nd rate hike in December, 2022

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