Possible Interest Rate Hikes in 2022 – Investment Implications

December 17, 2021

Federal Open Market Committee (FOMC) Meeting Decision

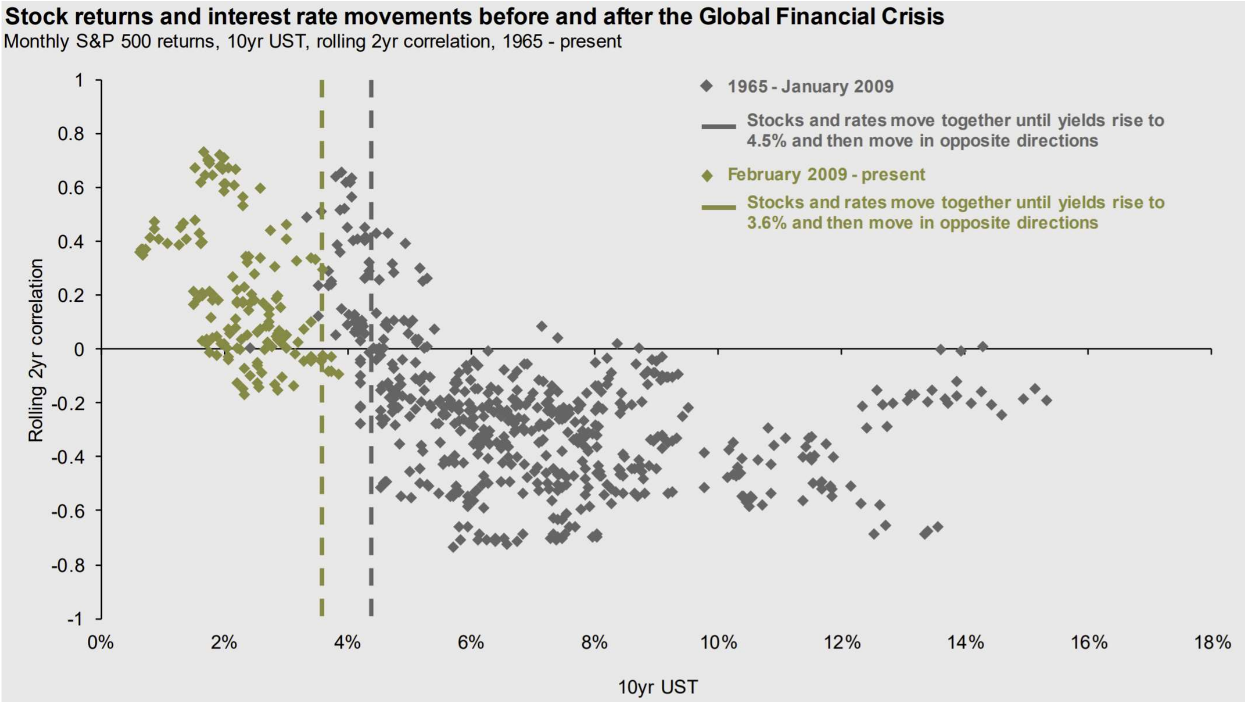
The FOMC met on December 15th and announced that the current accommodative monetary policies of bond purchases and a low Federal Funds Rate (FFR) will be ending due to employment gains coupled with high levels of inflation. The FOMC is growing concerned that inflation will be more persistent than previously thought and wants to take measures to address this. Therefore, current bond purchases will be reduced by $30 billion per month, putting them on track to wind this program down by March 2022. Sometime after this, it was signaled that they plan to raise the FFR in three 0.25% increments in 2022 and 2023. The current FFR is in the 0.00-0.25% range, implying that rates would rise to 1.0% in late 2022, and 1.75% by the end of 2023.

Economic Implications

The FOMC does not want to harm the economy by raising rates too fast, so they are only signaling modest interest rate hikes in 2022. If interest rates rise by 0.75% in 2022 as expected, this would be a slow pace of hikes by historical standards and would likely not negatively impact the economy. In addition, while the FOMC did not signal a specific date for interest rate hikes, it is assumed that it would not be until June of next year. A lot can happen between now and then, as we are still dealing with COVID and the economy is doing well but is still fragile. The FOMC will be closely monitoring the impact interest rate hikes are having on the economy and will adjust as the situation dictates. Therefore, we believe that it is premature to assume that these rate hikes are fate accompli.

Implications For Equities

The graph below indicates that modest interest rate hikes have historically not negatively impacted markets. In fact, since 2009 stocks and interest rates move in the same direction until rates exceed 3.5%, signaling that stocks can still go up in a rising rate environment. Nevertheless, we believe that stocks would hit a headwind at a lower threshold than 3.5% but believe that rates of less than 1.75% by the end of 2023 would not significantly negatively impact equities. However, stocks have performed well the past 5 years, and we do believe that investors should expect more modest returns and volatility going forward.



Source: JPMorgan Guide to the Markets (12/16/2021)

Implications For Fixed Income

Higher interest rates would be welcomed by bond investors for new purchases. Of course, bonds purchased before the expected rate hikes would be pressured due to the inverse relationship between bond prices and interest rates. If rates are increased at the slow pace that the FOMC is signaling, we would not expect severe pressure on bond prices. Total expected bond returns will still be modest going forward, but an improvement over recent history.

Conclusion

We are entering into a period of greater uncertainty as the FOMC must navigate higher inflation, lingering COVID and a fragile economic recovery. We expect more volatility in equity and bond prices as investors navigate this environment. It is important to remember that corporate America is in an extremely healthy state and consumer balance sheets are strong. It was unreasonable to expect interest rates to stay at essentially zero forever. It is actually a relief that we are moving to a more normal monetary policy which will still be quite accommodative. Business and consumers can still thrive in an environment of modestly rising rates. Our concern would elevate if the FOMC signaled a much faster and higher rate of hikes which we believe is unlikely but is on our radar. As always, we will continue to keep you abreast of developments and our views as they unfold.

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