Equity market compass in the Fed's hiking trail

What the length of the US interest rate cycle and slope of the yield curve can tell investors

Macroeconomic Research

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Key points

- **Focus on the length of the cycle:** We note that long hiking cycles of more than 15 months hit equities harder than short cycles, with an underperformance of around 3%
- **We can learn from the slope of the curve:** We observe that it is only six months after the first hike that the long cycles truly distinguish themselves from short cycles through yield curve flattening
- **Dividend yield, value and quality:** Value, dividend yield and quality in terms of styles seem to potentially offer the best mix of forward performance and hit ratio during rate hike cycles.

When the Fed drives sentiment

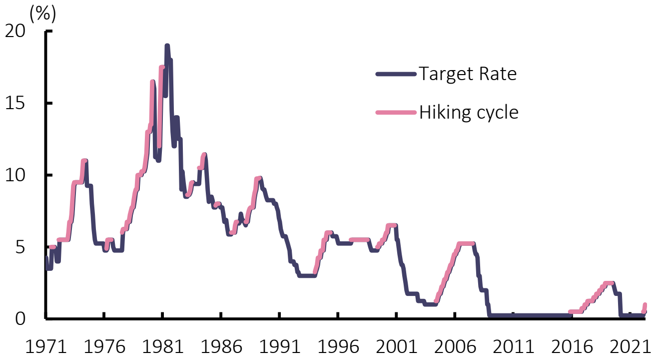
The influence of the US Federal Reserve (Fed) places it among the key protagonists of the economic and market environment. While its dual mandate of price stability and full employment dictates its monetary policy decisions, the anticipation and interpretation of its communication drives the sentiment of investors around the globe.

While the Fed changed its tone on the transitory nature of inflation at the end of 2021, it was the start of its tightening cycle in March which marked an end to the low-rate environment. The end of the Fed's accommodative regime will likely mean a reassessment of many investors' allocation across asset classes.

But to begin with, how do we define a hiking cycle? To avoid any "perfect forecaster" bias, we define a hiking cycle as the period between the month of the first-rate hike and the period before the first rate cut (Exhibit 1). Using this approach, we count 14 rate hiking cycles including the one started in March 2022.

Exhibit 1: US policy rate and hiking cycles

US Federal Funds Rate



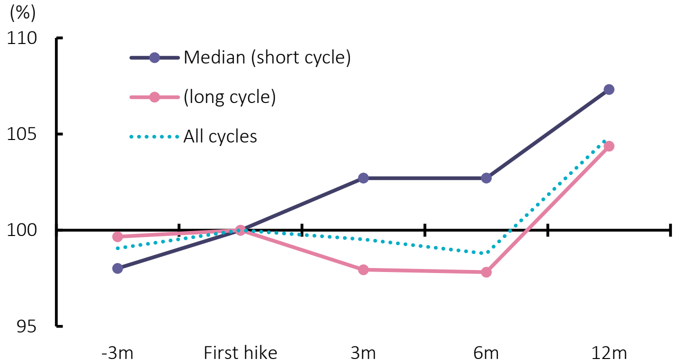
Source: Refintiv and AXA IM Research, 5 July 2022

Stock market and hiking cycles

Rate hiking cycles do not necessarily correspond to inflationary cycles, so a strategy aiming to protect against inflationary periods does not overlap perfectly with a strategy aiming to hedge against rate hikes, although often these two events are deeply linked.

Exhibit 2: An equity market buying signal over 12 months?

Global equity performance and hiking cycles



Source: Refinitiv, MSCI and AXA IM Research, 5 July 2022

According to the median outcome, stock prices grow by 4.9% over the 12 months following the start of a rate hiking cycle (Exhibit 2). However, the path is tortuous. In 50% of the cases, the six months following the increase are negative and the median performance is -1.2%.

Tightening monetary conditions, rising capital and borrowing costs, and the rising discount factor used to discount equity prices (all else being equal) are adverse factors for the asset class. But as rate hikes generally correspond to times when the economy is doing well, the median outcome is a rise of 3.6% over the three months preceding the first hike.

The length of the hiking cycle also appears to differentiate the performance of stocks. On average, hiking cycles last 15 months and we count seven long cycles (more than 15 months). In those cycles global equities perform worse, rising over 12 months by 4.4% on average during long cycles versus 7.3% during short cycles.

What we can learn from the slope

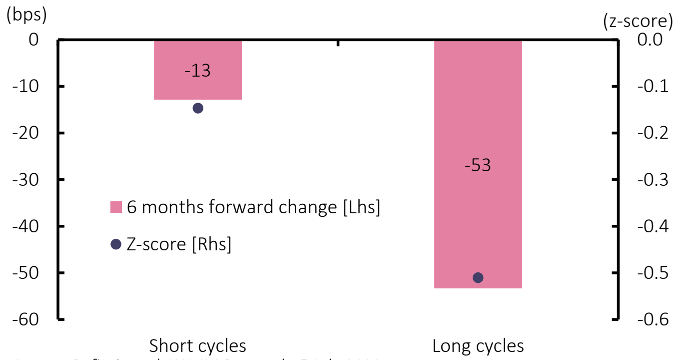
An obvious question is how do we distinguish a long cycle from a short one? The macroeconomic fundamentals of each cycle do not allow us to infer how long a cycle might last.

So, can the US Treasury debt yield curve tell us more? Assuming the slope of the yield curve reflects investors' expectations of US monetary policy, we investigated whether the yield curve can provide information on the length of the cycle.

For this purpose, we observed the changes in the slope of the curve following the start of the hiking cycle for the slope between short rates below three months and long rates above five years.

Exhibit 3: A more severe curve flattening in long cycles

US Slope changes following the start of the cycle



Source: Refintiv and AXA IM Research, 5 July 2022

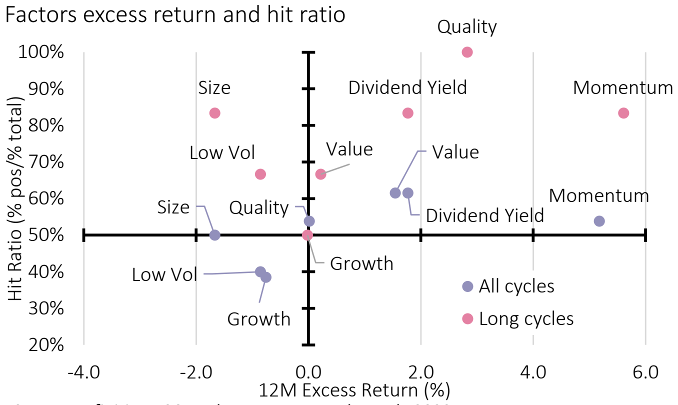
Long hiking cycles distinguish themselves from short cycles six months after the first hike (Exhibit 3). The curve tends to flatten or even invert significantly during long cycles.

In terms of magnitude, this amounts to about -0.5 standard deviations for long cycles versus -0.1 standard deviations for short cycles, or -53 basis points (bps) for long cycles versus -13bps for short cycles, which differs only marginally from the average change in the six-month yield curve.

Styles and hiking cycles

In this section we examine how the hiking cycle characteristics affect performance across investment styles and factors. Most styles perform according to investors' interpretation of risks through the economic cycle, so the styles' risk premia reflect the investors' perceptions. Exhibit 4 shows us the 12-month median excess returns and hit ratios (the percentage that is positive) of the different styles in hiking cycles.

Exhibit 4: Some styles offer a cushion in hiking cycles



Source: Refinitiv, MSCI and AXA IM Research, 5 July 2022

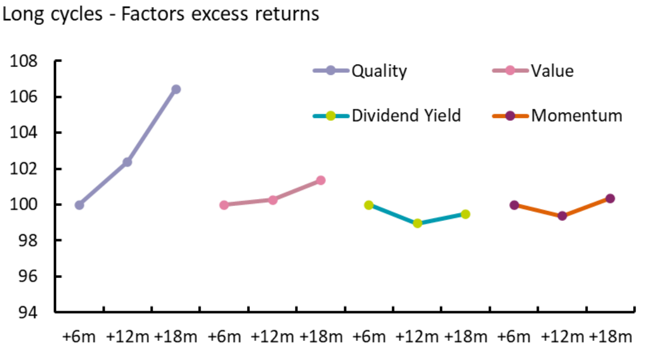
Across all the rate hike cycles of the Fed, three factors offer an interesting mix between excess return and hit ratio: value, dividend yield and momentum.

After 12 months, the first two factors offer an excess return of 0.6% and 2.0% respectively. The short duration bias of the stocks in these indices creates an opportunity for equity investors to have lower exposure to interest rates.

While the momentum style offers the best excess return 12 months after the start of a hiking cycle, its 50% hit ratio makes it uncertain – like flipping a coin. When hiking cycles are initiated at times of healthy economic growth, momentum strategies have tended to perform well. Thus, anticipating a resilient macroeconomic outlook is key for this strategy to work.

In practice, the identification of a long cycle is difficult. Assuming that an investor is able to distinguish the length of the cycle six months after its start based on the yield curve, we look at the return of these factors after the first six months (Exhibit 5).

Exhibit 5: Late market entry not a handicap



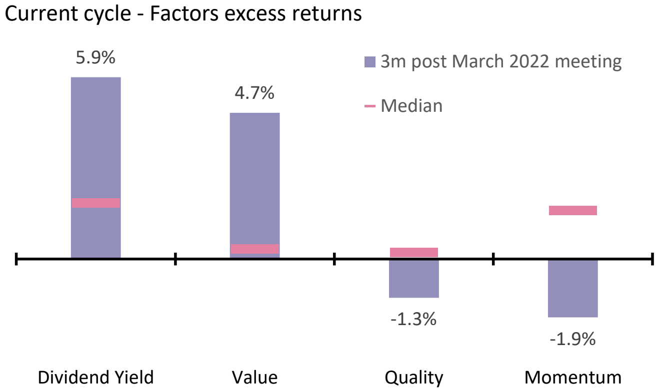
Source: Datastream, MSCI and AXA IM Research, 5 July 2022

Here we position ourselves six months after the start of a hiking cycle. In this setting, the quality and value factors seem more appealing in the six months onward Indeed, these are the only two factors that have consistently delivered a positive excess return. The dividend yield (-1.1%) and momentum (-0.6%) factors are struggling during this period while rebounding slightly after six months.

In long cycles, quality appears compelling. This factor delivers a median excess return of 2.8%, 12 months after the start of the hiking cycle. Moreover, this factor has consistently outperformed the market in the seven long cycles identified, which translates into a hit ratio of 100%. In theory, this factor benefits from economic downturns. Thus, companies with sustainable business models and sustainable competitive advantages have tended to be favoured in long hiking cycles.

What about the current cycle? The start of the Fed tightening in March 2022 led to a considerable rise in real rates, which moved back into positive territory in April. Since then, the performance of factors seems to be consistent with those observed historically, except for momentum (Exhibit 6).

Exhibit 6: Current situation is so far consistent with the past



Source: Datastream, MSCI and AXA IM Research, 5 July 2022

The dividend yield (+5.9%) and value (+4.7%) factors outperformed the market in the three months following the March Fed meeting, driven by the short duration bias versus the broader market.

Quality (-1.3%) underperformed, but the bulk of its historical performance comes after the first six months, so its upside potential is perhaps yet to be realised. Moreover, quality offers a historically interesting performance in a downward earnings revision environment. The uncertainty around the economic growth outlook indicates that downward revisions to come are likely to be material.

Lastly, investor sentiment is becoming less bullish and the momentum factor has underperformed (-1.9%). The Fed's rhetoric about the risk of damaging growth by continuing to raise rates in response to galloping inflation has added headwinds to the economic growth outlook and thus to the sentiment towards equities.

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Implications of hiking cycles vary

Empirical evidence of the relationship between US central bank policy rates and equities shows us therefore that the implications of rate hike cycles vary. The variability of the macroeconomic environment complicates matters for investors despite the guidance provided by policymakers.

In general, stocks have tended to rise 12 months after the first US central bank rate hike, but the path can be tortuous.

Focus on the length of the cycle: It is interesting to note that long hiking cycles of more than 15 months are harder for equities, which on average underperform by 3% compared to in short cycles.

The slope gives information: Considering that the slope of the US yield curve reflects investors perception of US monetary policy, it is only six months after the first hike that long cycles can distinguish themselves from short cycles. Over six months, the curve tends to flatten four times more in long cycles (-53bps, -0.5 standard deviation) than in short cycles (-13bps, -0.1 standard deviation).

Favour Dividend Yield, Value and Quality: Across styles, Value, Dividend Yield and Quality seem to offer the best mix of forward performance and hit ratio. In the first few months after the rate hike cycle starts, the short duration bias of the first two styles has been shown to be an advantage within the asset class. For late-coming investors (six months after the first hike), the quality factor is an interesting bet. Companies with solid and profitable business models have on average delivered an excess return over a six-month (+2.4%) and 12-month (+6.4%) horizon.

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