MyStratWeekly
Market views and strategy
Ostrum ASSET MANAGEMENT

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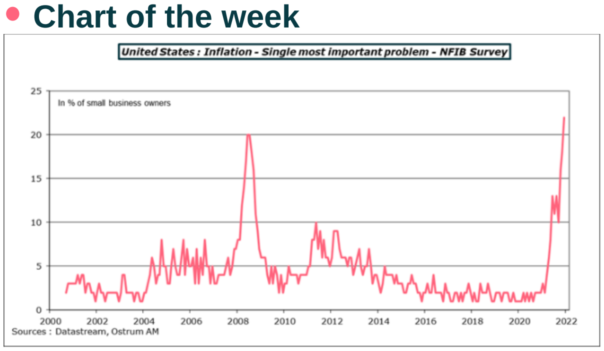
Topic of the week: The markets and the Fed's first hike

- **A study of markets around the first hike of the last four monetary cycles yield some interesting takeaways;**
- **A surprise hike (1994) leads to outsized bond market sell-off whilst transparent guidance may in fact impede tightening, causing financial instability;**
- **Equity drawdowns to the tune of 7-12% have been observed following initial Fed hikes, the strike price on the Fed's put's may be lower than many investors believe;**
- **The US dollar may weaken following the initial Fed hike.**

Market review: Feeling the cracks

- **Fed tightening is approaching**
- **Deluge of IG bond issuance in Europe and the US**
- **Equities: growth and defensives underperform value**
- **Weaker dollar, sharp rebound in the Japanese yen**

Chart of the week



The debate on the sustainability of inflation is partly off topic. Of course, one day inflation will fall. But it seems that the process is much longer than the economists expected.

In the meantime, the level of inflation is largely sufficient to create strong distortions. As a final example, the U.S. NFIB survey of small businesses shows that inflation is indeed becoming the main concern.

This is all the more dramatic given that the previous peak was in 2008 when oil prices had hit $140.

Figure of the week

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Source : Ostrum AM

176,000: for the first time, the number of electric cars sold in Europe exceeded diesel sales in December, reaching a record high of 176,000. This reflects government subsidies and tougher regulations to limit CO2 emissions.

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● **Topic of the week**

The markets and the Fed's first hike

The Fed's monetary strategy plays a determining role for the financial markets. The first hike often gave a direction for rates and stocks. We look back at the last four bull cycles to illustrate the current risks.

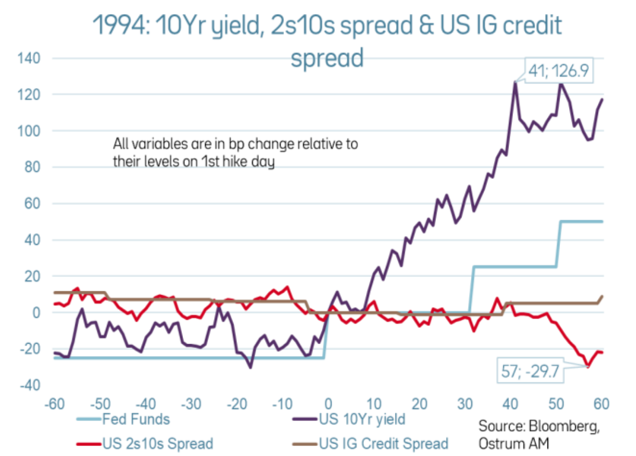
The importance of communication

1994: the textbook case of a surprise hike
7 hikes totaling 300bp over one year

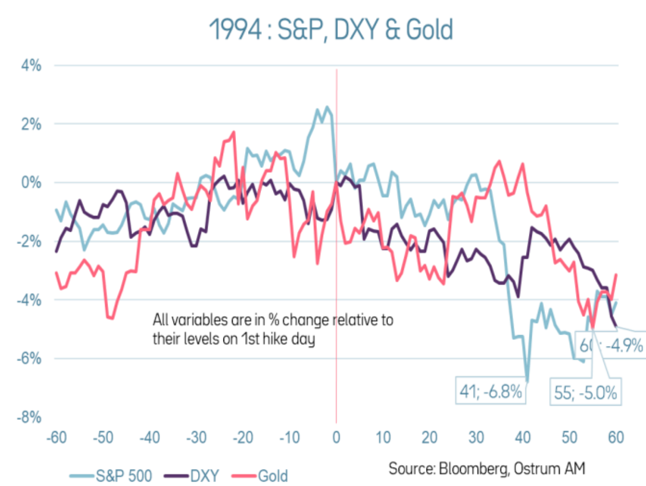
In 1994, the US economy was recovering from the 1990 recession, an oil shock and the ensuing military intervention in Iraq. The Savings & Loans crisis, lurking since the monetary tightening of the early 1980s, darkened the picture forcing the government to support the financial sector following the adjustment of real estate prices. There follows a jobless recovery typical of the hysteresis effects of a financial crisis. The sluggish economic recovery forced the Federal Reserve to be cautious before kick starting the rate cycle. The Fed Funds rate had been cut to 3%, around the level of current inflation. Zero real rates represented then a very accommodating monetary policy stance given the memory of the risk of inflation and high real rates in the 1980s. In addition, the Federal Reserve still had a quantitative target for the monetary base. As a deep recession hit Europe in 1993, market participants debated when the Fed would initiate its monetary cycle. Another peculiarity of the time was that the Fed did not issue a press release following the FOMC. With hindsight, the experience of 1994 tightening led Alan Greenspan to take steps to improve Fed communication.

When the Fed raised its rate for the first time on February 4, 1994, hike expectations disappeared and rate volatility largely subsided. This is therefore a major surprise, especially since the cycle will be far from linear: three increases of 25bp then two of 50bp, a new one of 75bp and a last movement of 50bp for a total of 300bp in one year. The erratic Fed action through 1994 indeed had a memorable impact on markets.

The following graph shows the evolution of the yield of the 10-year T-note, the slope of the curve (2-10 year spread), the spreads of the then developing IG credit market, over a period ranging from 60 working days before the first increase to 60 working days later. Date 0 represents the day of the first increase in Fed Funds. The second chart looks at the S&P 500, the dollar against a basket of currencies (DXY index) and the price of an ounce of gold. The series depict changes in basis points (1st graph) or in percentage (2nd graph) relative to their level on the day of this first increase.



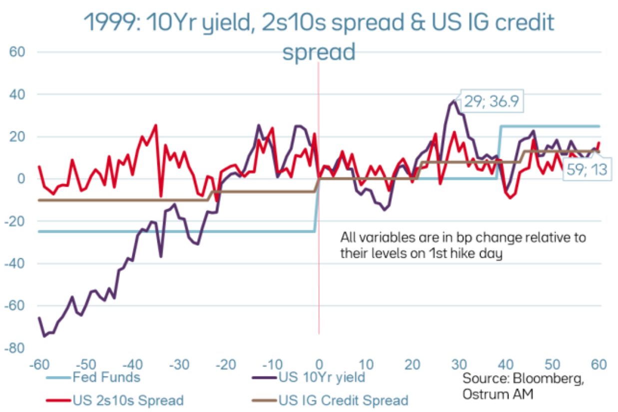
The 25bp hike on February 4, 1994 triggered a bond market crash. The US 10-year yield rose 127bp in two months' time (at day 41). As often during tightening phases, the yield curve flattened. The 2-10 year spread therefore fell by 30bp on the 57th day after a 3rd increase. Credit spreads were unchanged.



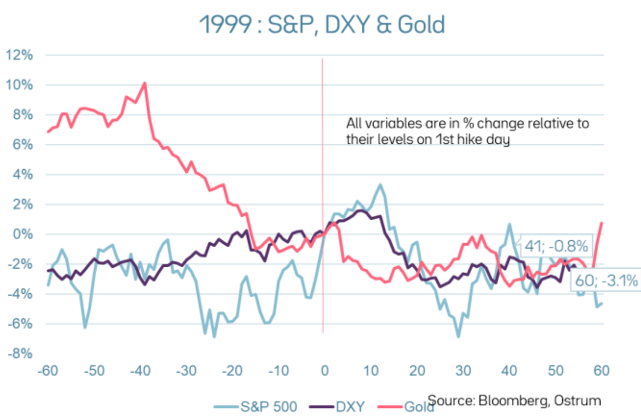
On the equities side, the upward acceleration in bond yields is mirrored by a drop in the S&P 500 (-6.8% on day 41). The first increase in Fed Funds hence weighed on stocks. Finally, it is interesting to note that the rise in Fed rates has been rather unfavorable to the dollar. The greenback lost nearly 5% in two months following the first rise. Gold is hit by the rate increase dropping 3% in three months. Monetary tightening undoubtedly reduced perceived inflationary risk.

1999: strong growth and insufficient tightening
6 increases for 175bp in total over 11 months

The cycle from June 1999 to May 2000 includes six increases, including five of 25bp then a final move of 50bp. The series of rate hikes then corrects a movement of relief comparable to an insurance policy against the impact of the external crises of 1997 in Asia (Thai baht devaluation) and 1998 with the default of Russia. The fall in stocks in the summer of 1998 and the bankruptcy of LTCM maintained a high level of uncertainty, but growth had remained very strong thanks to the productivity gains brought about by the diffusion of new communication technologies.



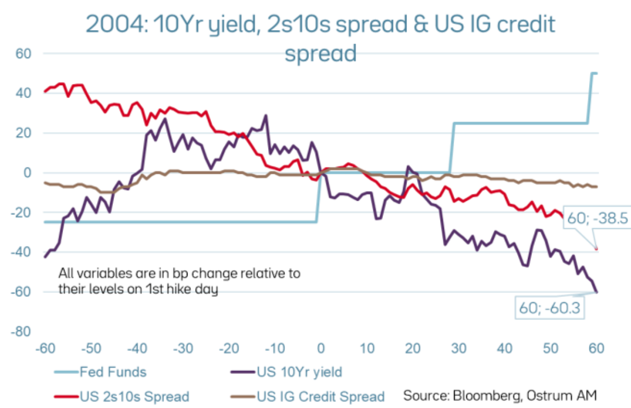
Long bond yields had correctly anticipated the Fed Funds hike and the entire curve had adjusted. At its peak, on the 29th day, the 10-yr note yield had nevertheless gained 36bp compared to the initial movement on June 30, 1999. Credit spreads widened slightly by 13bp over 3 months.



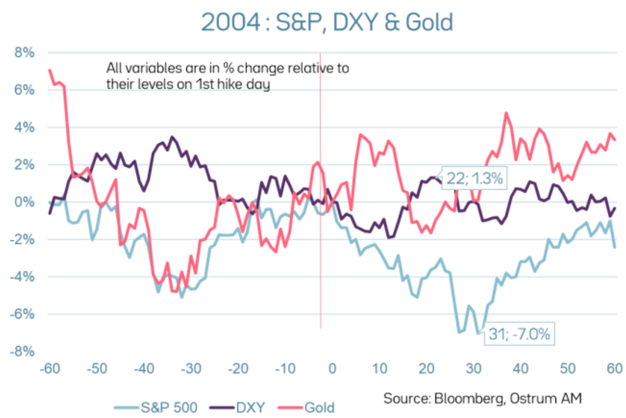
The hike in interest rates in June 1999 initiated a period of volatility and the S&P 500 fell by nearly 7%. The effect on gold is also immediate (-3.2% on the 13th day) but the bulk of the decline is observed earlier in the cycle, as market participants take into account the risk of higher interest rates. Once again, rising rates are causing the dollar to adjust lower.

2004: predictability can prove fatal
17 increases for a total of 425bp over 2 years

The 2004 cycle seems to echo the experience of 1994. The US economy is emerging from a long bear market initiated by the technology stock collapse, a significant number of defaults with spectacular bankruptcies (Enron, Worldcom) and the war in Iraq. After the 2000 to 2003 purge, the Fed wanted to be as transparent and predictable as possible. This cycle established the primacy of the financial cycle over the management of the economic cycle. Alan Greenspan distills warning messages of a hike well in advance speaking of a "considerable" period (7 months), then patience (3 months) before committing a series of 'measured' increases of 25bp at each committee during two years. There were 17 rate moves to raise Fed Funds from 1% to 5.25% over the life of the money cycle.

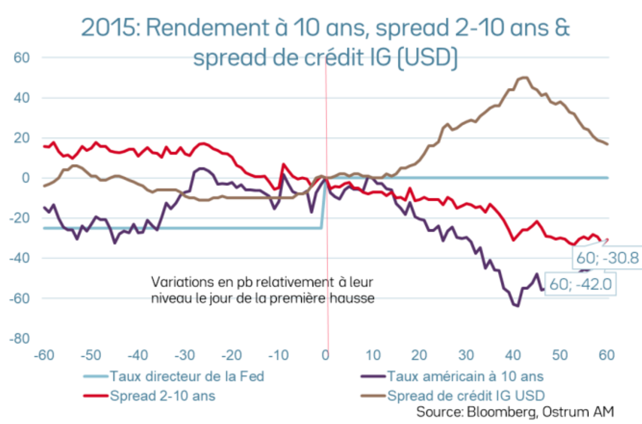


Transparency and the linear increase in Fed Funds in fact was a monetary policy error. The lack of uncertainty regarding the path of interest rates squeezed term premiums as the recycling of the current account surpluses of China and commodity-producing countries contributed to global excess demand for Treasuries, driving down bond yields. The 'long-term rate conundrum' according to Alan Greenspan is evidence of the failure of monetary tightening. The 10-year yield dropped by 60bp in three months' time amid significant flattening pressure. Rate guidance well in advance of the first hike had already initiated the flattening trade. Credit spreads narrowed at the margin. The fall in risk and term premiums undoubtedly played a major role in the development of the subsequent financial excesses that triggered the 2008 financial crisis.



Whilst aiming at "tighter" financial conditions, the Fed instead attracted considerable foreign capital flows that eventually fueled 'financial innovation' resulting in the frantic development of "subprime" mortgages. In short, a textbook case of the monetary backlash.

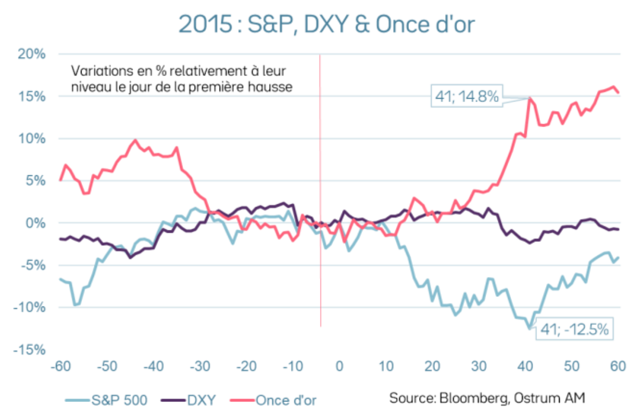
The S&P 500 fell by as much as 7% on the 30th business day before recouping the bulk of losses. The ounce of gold, arguably deeply undervalued at the time, helped to hedge the weakness in equity markets.



2015: between the trauma of 2008 and the weight of QE 9 increases for 225bp in total over 3 years

The December 2015 hike had long been delayed by Janet Yellen. The devaluation of the yuan in August 2015 seemingly posed a new threat to the global financial equilibrium. The trauma of the financial crisis was still present, and the lack of fiscal room for maneuver with a divided US Congress Arguably called for extended monetary easing. There was another operational difficulty linked to the successive asset purchase programs (QE1, QE2, twist, QE3, etc.). The Fed assumes significant duration risk that limits its ability to raise interest rates. In the words of Jean-Claude Trichet, it is not easy to put the toothpaste back in the tube. The Fed eventually hiked in both 2015 and 2016 before accelerating the pace of rate rises and allowing the balance sheet to wind down, always predictably.

As in 2004, the rise in Fed funds sparked a sharp flattening of the yield curve, as Chinese growth showed signs of weakening and the fall in oil prices reduced inflation. On the 41st business day, the yield on the T-note had dipped by 64bp from its December 15th close. The plunge in interest rates pushed credit spreads wider mechanically (+50bp mirroring the fall in yields) but the primary credit market remained open even as a wave of defaults hit the oil sector.



With the 2015 rate hike coming amid a troubled international climate, stocks lost as much as 12.5% in two months. Gold has played its role as a safe haven, perhaps in reaction to the previous Chinese yuan devaluation and dollar weakness.

Conclusion

A study of the market reaction to the first Fed Funds hike reveals some regularities. An unexpected rate hike favors an increase in long rates (1994). Conversely, transparent guidance ahead of the rate cycle tends to be followed by a decline in the 10-year yield (2004, 2015) as the term premium shrinks. Credit tends to under-react to the change in long-term rates. Stocks may plunge 7% to 12% in the two months following the initial rate hike. Lastly, the US dollar weakens on average as the money cycle begins.

Axel Botte

Market review

Feeling the cracks

Announced monetary tightening sparks a deluge of bond issues and sharp style rotations within equity markets

The rise in US rates is being held back this week by the weakness in equities. The US 10-year note oscillates violently in a 1.70-1.80% trading range. The communication of the US central bankers is nevertheless unequivocal as regards the direction of interest rates in the face of, "too high" inflation (7% in December) according to Lael Brainard. The equity markets exhibit higher volatility. Equity style rotation penalizes growth in favor of consumer cyclicals or industrial stocks. Commodity price pressure – nickel, for example, is trading at a 10-year high – is supporting stocks in the basic resources sector. The stabilization in bond yields also comes after a deluge of bond issues in the IG segment in euros and dollars. Spreads on sovereign debt and credit markets are nevertheless resisting pressure from the primary market. The unprecedented issuance total at the start of the year required significant interest rate risk hedging flows. It should be noted that gold and the Japanese yen are regaining their safe haven status against the backdrop of a weaker dollar. The euro jumps above $1.14.

The international backdrop remains troubled to say the least. Inflation risks dominate the news with the rebound in energy and metal prices. Oil is trading above $84 per barrel of Brent. At the same time, political tensions between Russia and the United States, and their European ally, over the situation in Ukraine are fueling the rise in gas prices on European markets. Russia cut off communication with the EU hours after a cyberattack targeted the Ukrainian government. The Biden administration is seeking to rally Europe to its strategy of sanctions currently being discussed at the US Senate by offering a solution on gas supply. For his part, Joe Biden must divert the attention of Americans from his domestic political difficulties. The Build Back Better stimulus plan has yet to pass the Senate, his polls plummet as consumer prices soar, and the Supreme Court has struck down the law making vaccinations mandatory in large corporations with more than 100 employees.

However, the economic situation in the United States is very good. Unemployment has fallen below 4% of the labor force and GDP growth is projected at 3.8% in 2022. Inflation at 7% in December remains however a significant issue, which explains declining household confidence since the summer. Core inflation is at 5.5%. Two-thirds of the consumer basket experience annual price increases of over 3%. The shelter component is 4% more expensive over one year. In addition, 12-month inflation expectations stand at 4.9% in the University of Michigan survey. Weaker retail sales (-1.9% m) in December may reflect some form of consumer retrenchment.

The markets seem to have priced in a scenario of three Fed hikes, or even four or five according to Governor Christopher Waller if inflation remains elevated. The 10-year note yield however stabilized about 1.75% in a volatile market environment. The auctions of 10- (1.72% highest auctioned yield) and 30-year bond (2.07%) were met with good demand. The trend remains for a flatter 2s10s spread (-9 bp last week) due to higher Fed Funds rates forecasts. In the euro area, the Bund moved within a trading range of -0.03% to -0.10%. Long-dated bonds continue to attract high investor demand around 0.30% on the 30-year Bund or OAT 2053, which yield eventually plateaued around 1%, as insurers and hedge funds went long. Sovereign spreads weathered Irish, Portuguese and Italian bond syndications and ended up flat for the week. The political agenda at the end of the month is likely to rekindle volatility. Greek debt (163 bp on the 10-year, +58 bp since October) seems the most fragile while the ECB remains evasive regarding its support for GGB markets. The stance of central bankers (De Guindos, Schnabel) is also hardening about the inflationary risks. Breakeven inflation rates, however, under-reacted to the rise in crude prices and the 5% inflation print in December.

Regarding credit, the deluge of primary market deals (already €25 billion in non-financial corporate bonds this year and €42 billion in various financial debt securities, including €17 billion in covered bonds) is weighing on spreads (+3 bp). Hybrid debt and fixed-income segments high beta underperformed as the IG spread curve steepens. Caution is warranted in the euro IG credit market, especially as the earnings season promises to be tricky. In the US, primary market issuance totaled $85bn contributing to a 4bp widening of US IG spreads.

In European high yield space, the market seems more resilient. The BB segment underperforms, due to a higher duration as optimism about Omicron favors the rebound in securities linked to the reopening of the economy and currently trading at an attractive discount. The theme of rising stars (potentially heading back to IG space) also appears to be long-lasting, which suggests being constructive on this segment of the high yield rating spectrum. Buying protection on the iTraxx crossover also makes sense to gain exposure to the outperformance of cash corporate bonds relative to equivalent CDS indices.

The increase in volatility is palpable across equity markets. Thematic (value vs. growth) or sectoral rotations (banks vs. defensives and technology) are driving market trends. Banks gained 8% while technology plunged 5% in the wake of a Nasdaq weakened by higher long-term rates. The adjustment of luxury stock valuations continues in Europe.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	17-Jan-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.57%	+1	+15	+5
EUR Bunds 10y	-0.04%	0	+34	+14
EUR Bunds 2s10s	53.5bp	-1	+20	+10
USD Treasuries 2y	0.97%	+7	+33	+23
USD Treasuries 10y	1.78%	+2	+38	+27
USD Treasuries 2s10s	81.3bp	-5	+5	+4
GBP Gilt 10y	1.16%	-3	+41	+19
JPY JGB 10y	0.15%	+1	-11	+1
€ Sovereign Spreads (10y)	**17-Jan-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	38.26bp	+6	+1	+1
Italy	132.51bp	+0	-3	-3
Spain	68.97bp	+1	-5	-5
Inflation Break-evens (10y)	**17-Jan-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2%	+0	+4	-10
USD 10y Inflation Swap	2.64%	-6	+1	-14
GBP 10y Inflation Swap	4.25%	+6	+5	+8
EUR Credit Indices	**17-Jan-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	98bp	+4	+1	+3
EUR Agencies OAS	48bp	+2	+0	-1
EUR Securitized - Covered OAS	45bp	+1	+0	-1
EUR Pan-European High Yield OAS	311bp	+5	-15	-7
EUR/USD CDS Indices 5y	**17-Jan-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	52bp	+1	+2	+5
iTraxx Crossover	258bp	+1	+4	+15
CDX IG	53bp	+0	+1	+4
CDX High Yield	307bp	-5	-3	+14
Emerging Markets	**17-Jan-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	383bp	+15	+12	+15
Currencies	**03-Jan-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.139	0.600	1.370	0.2
GBP/USD	$1.365	0.508	3.028	0.8
USD/JPY	JPY 115	0.559	-0.812	0.5
Commodity Futures	**17-Jan-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$85.8	$5.0	$12.3	10.35
Gold	$1 820.8	$19.1	$22.7	-0.46
Equity Market Indices	**03-Jan-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 663	-0.30	0.91	-2.2
EuroStoxx 50	4 300	1.42	3.33	0.0
CAC 40	7 192	1.07	3.83	0.5
Nikkei 225	28 334	-0.51	-0.74	-1.6
Shanghai Composite	3 542	-1.44	-2.50	-2.7
VIX - Implied Volatility Index	19.19	2.29	-11.03	11.4

Source: Bloomberg, Ostrum AM

Additional notes

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