

Monthly Market Update

Rates and Financial Conditions | January 2024

Dan Golosovker, James Liu (Clearnomics)

Key takeaways

- Swings in interest rates have driven market and economic volatility. However, there are signs that rate dynamics are shifting.
- Over the past year, higher rates across the yield curve helped to do the Fed's job of tightening conditions and slowing inflation.
- Rates have stabilized and fallen back as markets prepare for potential Fed rate cuts in 2024. It's an opportunity to revisit asset allocation strategies in this changing rate environment.

Market update

Perhaps more than any other factor, swings in interest rates have driven volatility across financial markets in 2023. However, nearly two years after the Fed began one of the most aggressive rate hike cycles in history, there are signs that conditions may be shifting. Inflation has improved, the 10-year Treasury yield is hovering near 3.9% and the Fed is expected to cut rates in 2024. The possibility that interest rates are near an inflection point makes it natural to revisit their effects on the economy and portfolios. What trends should investors follow as they continue to navigate this changing rate environment?

An important reason the Fed may begin cutting policy rates is that higher long-term rates have already helped to both drive inflation lower and slow some parts of the economy. While the yield curve has been inverted since mid-2022, with short rates high due to a federal funds rate between 5.25% and 5.50%, long-term rates have also been elevated. Higher long-term rates have broader effects than policy rates alone, and, in fact, the goal of the Fed is to influence all parts of the curve via its policy. This "yield curve control," when it works, also has implications for investors across equities and fixed income, as we have witnessed this year.

First, by definition, higher rates across the curve tighten financial conditions and help to rein in inflation. Since inflation's peak of 9.1% in June 2022, as measured by the Consumer Price Index



(CPI), price increases have moderated rapidly. In November, the CPI rose only 0.1% over the month, and prices increased just 3.1% from a year earlier.

At their most fundamental level, high interest rates restrict economic activity by shifting incentives for both businesses and consumers to save rather than spend. When interest rates are high, there are greater returns on saving, resulting in a shift in preferences on how to use the marginal dollar. Decisions made by individuals and businesses then lead to lower overall demand at an aggregate level, slowing the economy.

This also impacts businesses considering capital investments. When market-based interest rates increase, the cost of capital rises as well, most notably rates on bank loans and other sources of direct lending. As a result, projects that were viable in a low interest rate environment may no longer make sense. Rather than investing in projects that fuel hiring and expansion, businesses and investors may choose to save their capital and earn a “safer” return. These dynamics moderate demand in the economy, slow hiring and can drive inflation lower.

Second, just as volatile and increasing interest rates over the past two years have shaped consumption, the investment landscape has shifted dramatically over this period. In fixed income markets, rapidly rising yields have pushed down the price of fixed income instruments. The U.S. Aggregate Bond Index fell 13% in 2022, but it has rebounded nearly 5% this year as rates have come back down.

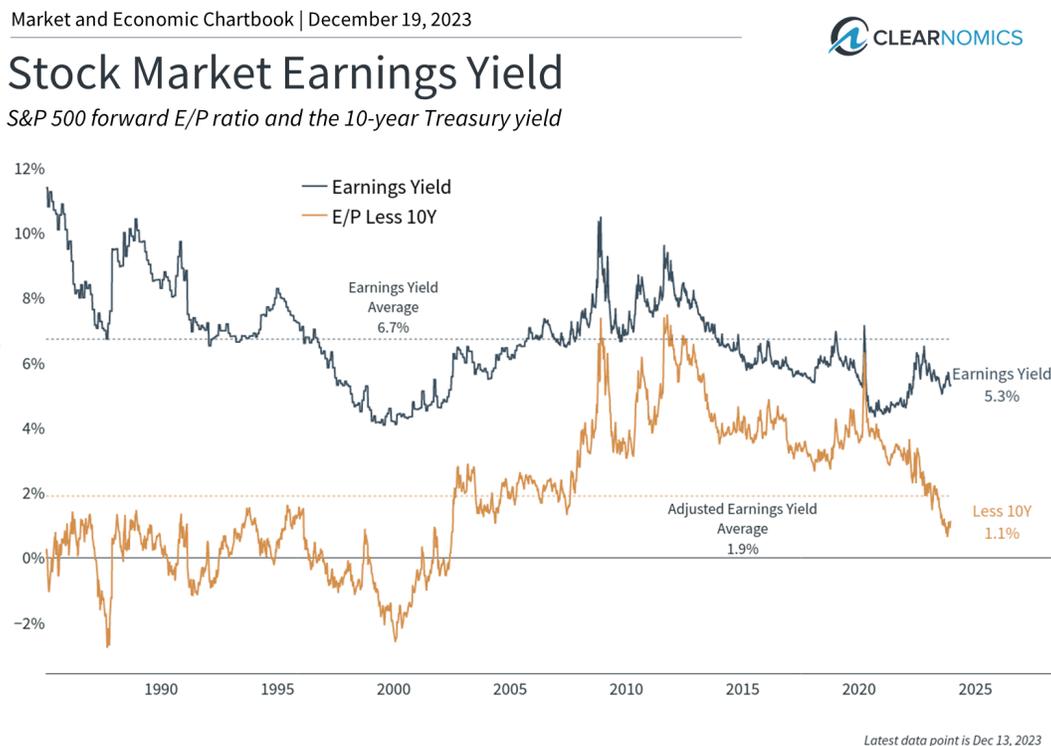
We should note that the banking crisis earlier this year was also a result of rapidly rising rates. Banks that had large portfolios of long-term debt incurred significant losses on their balance sheets, while fleeing deposits forced some to sell these bonds at a loss. While the banking system has since stabilized, and many larger banks have performed well throughout the crisis, more conservative banking activity and greater regulation can also serve to slow the economy.

Third, rising interest rates directly impact equity pricing. High inflation and interest rates create uncertainty around future cash flows, potentially leading to large swings in their present values. This leads to significant uncertainty in the overall value of companies, especially those whose businesses or products depend on future growth, driving volatility higher. 2023 can be characterized by strong index-level returns, driven by a rebound in tech stocks, but with several periods of heightened risk and market pullbacks.



Exhibit 1

Earnings yields have fallen relative to both real and nominal rates, driving the equity risk premium lower



Sources: Clearnomics, Standard & Poor's, Refinitiv

More formally, real rates impact the equity risk premium of the market, which is the excess return earned by investors for investing in risky assets over risk-free ones. The equity risk premium declined as Treasury yields rose. This made equities relatively less attractive when compared to fixed income investments. However, this has already begun to reverse as the stronger-than-expected economy propels higher earnings growth and rates moderate.

While high interest rates over the past two years were challenging for consumers and investors, it is important to consider how far conditions have improved over the last year. While the Fed is hesitant to declare victory on inflation, higher rates across the yield curve have done much of the work for them. If rates do fall further in the coming year, beginning with the short end of the curve as the Fed cuts policy rates, many of these effects across fixed income and equities could also reverse. In this environment, it's more important than ever to carefully rethink asset allocation strategies to prepare for the next stage of the cycle.



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