

## The Fed is Coming! The Fed is Coming!

### January 2021

The 1966 Carl Reiner comedy classic “The Russians are Coming!” spoofs the Cold War tensions of the 1960s and the midnight ride of Paul Revere warning of a British invasion 200 years earlier. When a Cold War era Soviet submarine runs aground on Gloucester Island off Massachusetts, hilarious panic ensues as the town believes it’s a full scale invasion. The reality was the submarine just needed a tow.

When Fed Funds Rates are low and economic indicators are improving, we know that at some point “The Fed is Coming.” Economists and investors alike will turn their eyes to the Fed for signals indicating when the interest rate hike cycle will begin. Many investors attempt to get ahead of Fed movement by making changes to their asset allocation strategy; some will even forego their investments in credit opting for cash positions to escape potential volatility caused by rising interest rates. Here we examine the Investment Grade (“IG”) Corporate credit markets compared to the 3 Month Treasury Bill, our cash equivalent. Our goal is to see if these investor reactions are the bold and brave actions of Paul Revere or potentially the panicked overreaction of the good people of Gloucester.

Since 1990 we have seen the Fed increase rates 40 times, which can broadly be grouped into 5 interest rate hike cycles, the average cycle lasting 27.2 months<sup>1</sup>. On average 1, 3, 5, and 10 years after each hike during the Fed’s hiking cycle, Investment grade Corporate Bonds<sup>2</sup> have significantly outperformed the 3 Month T-Bill<sup>3</sup>.

#### *Average Cumulative Returns Post Rate Hike*

	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>10 Year</u>
3 Month Treasury	3.82%	12.32%	17.82%	26.86%
IG Corporates	5.77%	17.10%	38.23%	85.39%

*Cumulative Returns were totaled then averaged.*

#### *Average Annualized Returns Post Rate Hike*

	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>10 Year</u>
3 Month Treasury	3.82%	3.94%	3.31%	2.34%
IG Corporates	5.77%	5.29%	6.65%	6.33%

*Annualized returns were first annualized then averaged.*

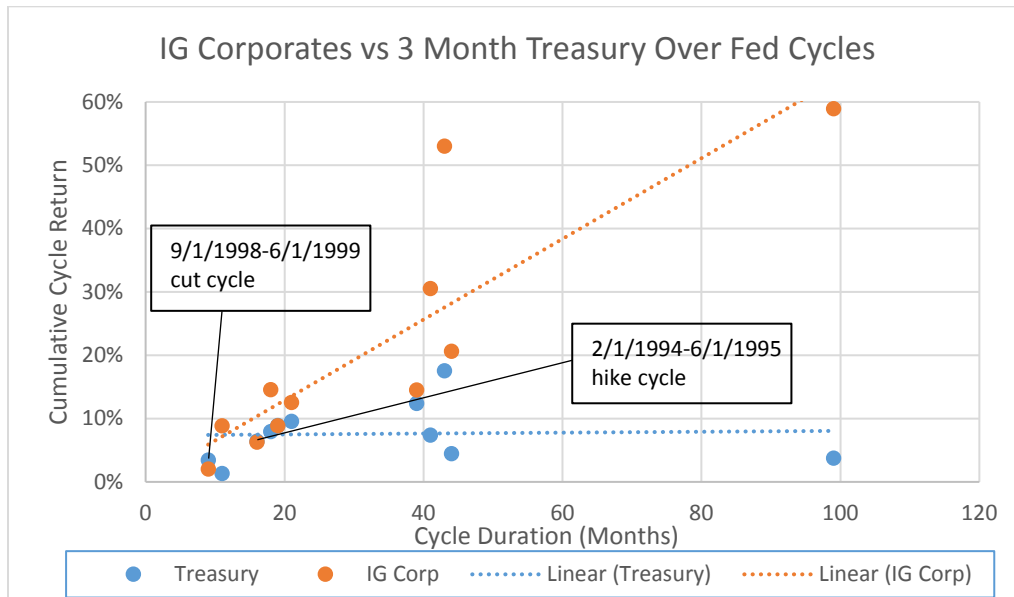
In fact, the longer the interest rate hike cycle continued the better the relative performance of Investment Grade Corporate credit versus the 3 Month T-Bill. The 44 month time period from 12/2015 until 8/2019 saw Investment Grade Corporates cumulatively outperform by 16.2%, a 4.1% average annual outperformance. This trend persists if the Fed is in a cutting or hiking cycle as well. Counterintuitively, Investment Grade Corporate credit’s

<sup>1</sup> Start and end of Fed rate hike / cut cycle defined as performance from the start of the month where hike / cut took place and ending the start of the month of Fed policy change.

<sup>2</sup> Investment Grade Corporate Bonds represented by the Bloomberg Barclays Investment Grade Corporate Bond Index. The index is unmanaged and does not take into account fees, expenses, and transaction costs. Data Source: eVestment

<sup>3</sup> 3 Month Treasury Bill Data Source: eVestment

largest period of underperformance came during the Fed rate cut cycle of 1998-1999 where T-Bill's outperformed by 1.41% cumulatively, 1.09% annualized.



This is not to say that Investment Grade Corporate always outperforms 3 Month T-Bills during Fed rate hike cycles. There have been two occasions in the last 30 years that IG Corporate credit would have underperformed between the start and end of a Fed rate hike cycle. The Fed began raising interest rates in February of 1994 where it increased rates 7 times in the 16 month period ending in June of 1995. During this time period the 3 month T-Bill's cumulative outperformance versus the IG Corporate credit index was 17 basis points.

Time Period	3 Month T-Bill Cumulative Return	BB IG Corporate Index Cumulative Return
February 1994 – June 1995	6.46%	6.29%

The 1994-1995 time period known as the "Great Bond Massacre"<sup>4</sup> was marked by volatility across all bond markets of the developed world. Generally recognized as the worst period in the history of the fixed income markets, the "Great Bond Massacre" saw a confluence of rate movements, geopolitical events, and foreign divestment in U.S. debt. While Fed policy undoubtedly had an influence on performance here, these multiple factors drove volatility in the bond market. Despite the volatility, IG Corporate credit underperformed 3 Month T-Bills by only 17 basis points and yielded a positive return for investors.

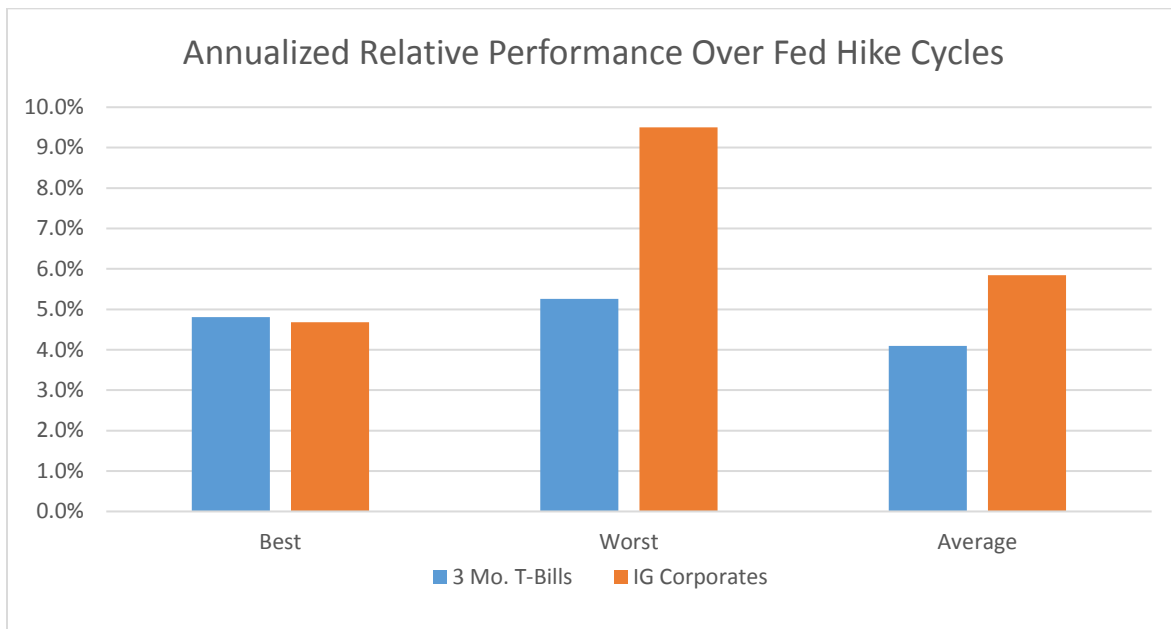
June of 1999 through September of 2001 was another period where we saw the 3 Month T-bill outperform IG Corporate credit. During this hike cycle, we saw 6 rate hikes over 18 months and 9 basis points of outperformance by 3 Month T-Bills.

Time Period	3 Month T-Bill Cumulative Return	BB IG Corporate Index Cumulative Return
June 1999 – January 2001	8.95%	8.86%

<sup>4</sup> The "Great Bond Massacre" is generally referred to as the period between 1/94 and 9/94

Again, Fed policy certainly influenced credit markets during this time period though this time period is more marked by the bursting of the “Tech Bubble<sup>5</sup>.” The fallout from the Tech Bubble produced an environment with a crisis of investor confidence, accounting scandals, and steep market declines. Here IG Corporate credit underperformed the 3 Month T-Bill by 9 basis points while still generating a positive return. Investor behavior and reactions to wild market swings during this time period cannot be discounted as significant influencers on performance.

The two scenarios above highlight periods of time where an allocation away from IG Corporate credit to the safety of 3 Month T-Bills may have been beneficial; however, the benefit would have been relatively small and required perfect timing. Even if an investor were able to time the reallocation at the start of a rate hike perfectly, a positive outcome is not guaranteed. Since 1990 the worst case scenario of a reallocation away from IG Corporate Credit to 3 Month T-Bills at the start of a rate hike cycle, and keeping that allocation consistent through the end of the hike cycle<sup>6</sup>, would have been an annualized underperformance of 425 basis points. On average, it would have produced a detriment to performance.



When Fed Funds Rates are low and there are positive economic indicators, we know that “The Fed is Coming.” Eventually, the Fed will embark on a rate hiking cycle. However, the usual questions of when, how long, and the magnitude of that cycle is anyone’s guess. History tells us that trying to time Fed rate hike cycles may be an overreaction that yields little, if any, benefit. The data above suggests a long term holding of IG Corporate credit has yielded better investor outcomes than the 3 Month T-Bill, and periods of IG Corporate credit volatility may be more explained by macroeconomic conditions other than Fed rate movements.

<sup>5</sup> The “Tech Bubble” is defined as the period of 1/95-3/00. Investors with more questions about the turnaround in 1999 are encouraged to read *A Year in Review 1999* by Floyd Norris 1/3/00

<sup>6</sup> Fed hike cycle starting December 2015

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