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Much Ado About Interest Rates

October 9, 2023

Dear O'Brien Client –

After a solid start to the year, investors have taken a step back from asset markets since August, resulting in the first down quarter for both stocks and bonds since 3Q 2022. The main culprit behind this market pullback appears to be a relatively staid corner of the investment universe: U.S. treasuries.

In 1Q, the Federal Reserve (Fed) raised interest rates above the pace of inflation – a threshold at which many investors consider monetary policy to be restrictive to future economic growth. Since that time, the Fed has enacted two additional rate hikes while inflation has continued to slow, further pushing monetary policy into restrictive territory.

Investors had until recently been willing to look past this, as they expected that the Fed would shift to rate cuts once inflation had cooled to a pace in-line with their 2% core inflation (i.e., excluding volatile food and energy prices) mandate. Over the past three months, core inflation has indeed been running at the equivalent of that 2% pace.

But despite that development, the Fed has not shown willingness to back away from their tightening bias. Indeed, in their most recent meeting they indicated that they expect to hike rates one more time this year and keep rates elevated once they conclude tightening for an extended period.

Some of that stance is likely posturing. Continuing to talk tough on inflation helps the Fed's credibility and potentially reduces the need to raise rates further. But that stance also means that monetary policy will become increasingly restrictive if inflation continues to slow over time – raising the risk the Fed overtightens and pushes the economy into recession.

At the same time, the federal government continues to use deficit spending to fill the gap in the federal budget. The 2023 budget is poised to be the fourth consecutive budget with a deficit exceeding $1 trillion. The cumulative deficit of the past four years is on track to exceed the cumulative deficit from 2009-2019, despite economic activity post-Covid being generally stronger than during that prior period.

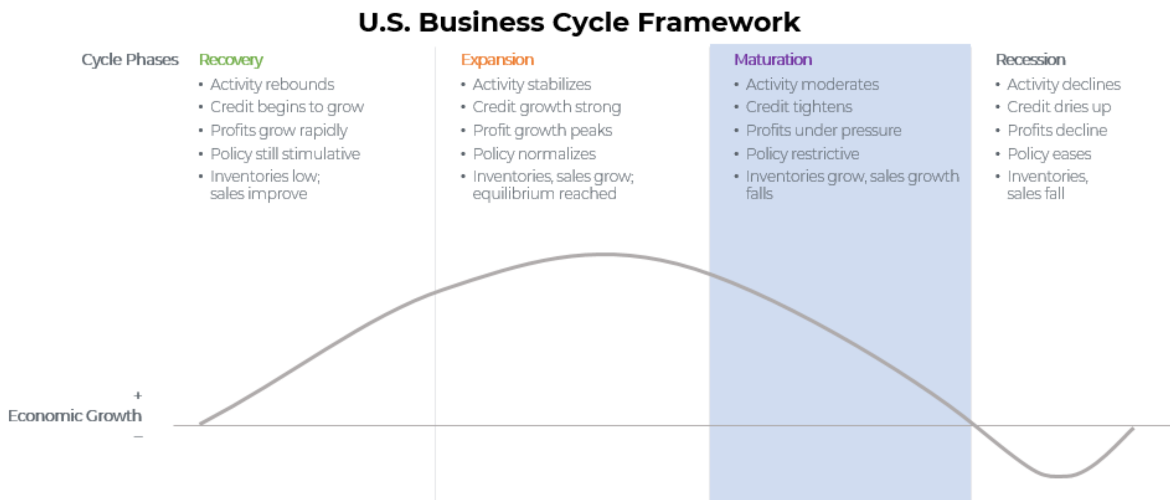
This surge in treasuries being issued to finance those deficits creates further upward pressure on interest rates. The continued grind higher in rates, in turn, is once again adversely impacting growth stocks, the primary driver of equity markets this year. Because growth stocks are expected to experience the bulk of their profits in the future, they are more sensitive to movements in interest rates. Higher rates reduce the discounted value of those future earnings, fueling the downturn in the equity market over the past two months.

Against this backdrop the debate about whether the U.S. economy will achieve a "soft landing" (i.e., avoid a recession) continues in earnest. Yet this dialogue misses a simple truth: business cycles always ultimately end in recession.

While the idea that a recession is always on the horizon – whether near or longer term – can be uncomfortable, it is important to remember that recessions serve an important role in that they tend to rapidly reset economic and financial market imbalances before they become more acute crises.

Although there will always ultimately be another recession, predicting when it will occur is the challenge. Past performance is no guarantee of the future, but when looking at the periods preceding recessions in prior U.S. business cycles, there are certain economic dynamics that have consistently appeared. They include:

- A moderating pace of economic activity and hiring.
- Banks becoming less willing to lend money to businesses and consumers.
- Corporate profits and profit margins falling under pressure.
- Monetary policy becoming outright restrictive.
- Rising inventories as companies struggle to sell the goods the produce.



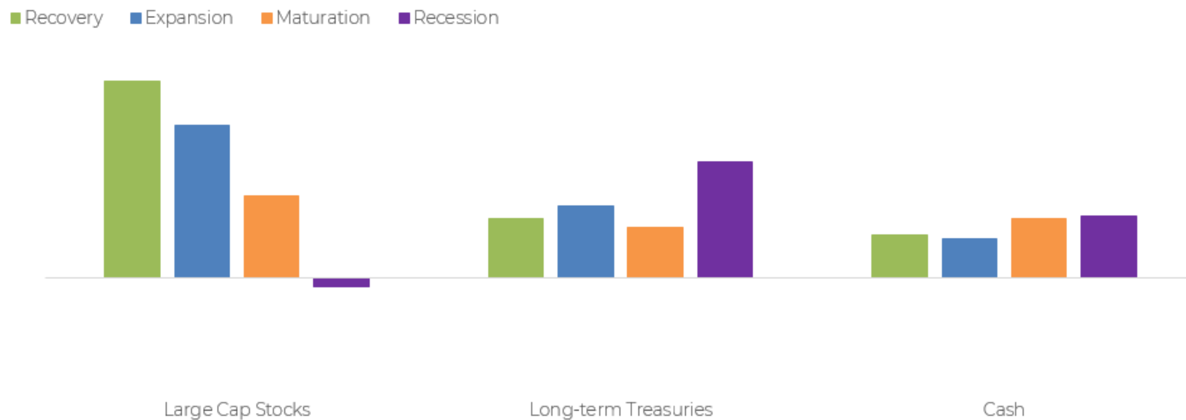
The diagram above is a hypothetical illustration of the business cycle, the pattern of cyclical fluctuations in an economy over a few years that can influence asset returns over an intermediate-term horizon. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Source: Fidelity Investments (AART), O'Brien Wealth Partners, as of 9/30/23.

Economic activity has been resilient so far in 2023, but it is not hard to see some of these trends unfolding as we enter 4Q. Interest rates are now higher than the pace of inflation and corporate profits have weakened. Labor markets remain strong but are showing signs of growing slack.

As shown in the blue box above, these types of dynamics are typical of what we call the Maturation phase of the business cycle. Every business cycle is unique, so there is not necessarily a specific amount of time that the U.S. economy remains in this (or any other) phase. But historically, the U.S. economy has flowed through each of these four phases in succession as the economy moves in and out of recessions.

We believe the U.S. economy is currently in that Maturation phase. This backdrop has historically correlated with positive, but relatively subdued returns from markets (see the orange bars in the chart below) and therefore generally has not been an environment where taking excessive risks in markets has been rewarded. It has also meant that before experiencing the next sustainable economic upswing, a recession has occurred.

While Maturation phases coincide with positive, albeit subdued, returns, recessions tend to coincide with negative returns (purple bars below) from risk markets such as equities. But recessions also tend to coincide with above average performance from higher quality markets, such as those treasuries that have been under such extreme pressure the past few years.



Business Cycle phases as identified by O'Brien Wealth Partners. Source: Morningstar Direct, Ibbotson, CFA Institute, O'Brien Wealth Partners, as of 12/31/2019.

Importantly, recessions are usually brief (under a year in length, on average), particularly when compared to the long-term investment horizons we are focused on reaching. Markets are also forward looking. In other words, markets tend to bottom before economic activity does in anticipation of entering that Recovery phase (green bars above) where stocks tend to experience their strongest performance. On average, global equities have rallied 68% in the first year after bottoming out during the last three recessions[i].

All of this highlights both the importance of the economic backdrop for return expectations, as well as how challenging it is to time movements both out of and back into those markets successfully. As such, we see the following implications for investing going into 4Q:

- We are not predicting an imminent recession, but we also do not believe it is time to take on new risks.
- During market volatility do not lose sight of long-term goals by staying invested.
- Within asset classes, seek allocations that historically hold up better as growth softens, such as treasuries in bonds and U.S. large cap stocks in equities.
- Identify investments that tend to benefit from economic rebounds that follow recessions, such as non-investment grade credit and small-cap stocks.
- Maintain asset class allocations and rebalance portfolios if deviations between asset classes weights and Investment Policy Statement targets become too large.

We hope you are all taking care and staying healthy. If you have questions, or would like to talk, please reach out to your Advisor or any member of our investment team.

Your O'Brien Team

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[i] Stocks: MSCI All-Country World Index (ACWI). Source: Bloomberg Finance, LP, O'Brien Wealth Partners, as of 3/24/23.

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