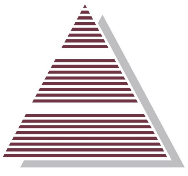


KARPUS INVESTMENT MANAGEMENT

COMMENTARY

January 2022

Rate Hikes on Deck?
A Quick Recap and Analysis

Since the pandemic began, the U.S. Federal Reserve (Fed) has been extremely accommodative by keeping rates low and purchasing assets. It has taken these actions to aid in the economic recovery and to achieve its dual mandate of maximum employment and stable prices.

With high inflation, unemployment at a post-pandemic low, and supply-chain constraints (among other factors), the Fed has recently shifted to a more hawkish tone.

For example, in early November 2021, the Federal Open Market Committee (FOMC) announced it was tapering its asset purchases and just one month later, it doubled its reduction of purchases.

Another example is the Fed's "dot plot," which is a chart released by the Fed to illustrate FOMC participants' outlook on the path of interest rates. In the dot plot released following the Fed's December 2021 meeting, all 18 of the FOMC's participants projected the Fed Funds Rate to rise in 2022, with the majority of members projecting three 0.25% rate hikes by the end of 2022.

Lastly, minutes from the Fed's December 2021 meeting (released on January 5, 2022) also illustrate this change in tone, with a distinct shift away from its transitory inflation position and an indication that it saw the labor market as very tight.

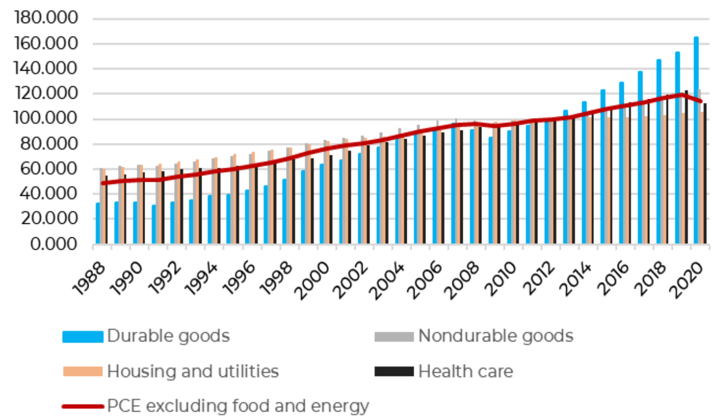
Upon the news release, broad domestic equity markets (represented by the S&P 500 Index) started a correction after hitting an all-time intraday market high of 4,818.62 just one day before on January 4, 2022.

Over the next few months, we believe the market can witness periods of volatility as investors rebalance and hedge portfolios in preparation for the anticipated rate hike. Although past performance is not an indicator of future returns, we've found that periods of fear, speculation, and volatility are where investment opportunities can present themselves.

Looking back at the past five Fed rate hikes (shown in the table below), we found that, on average, growth equities outperformed both value equities and taxable bonds (as measured by the Russell 1000 Growth Index, the Russell 1000 Value Index, and the Bloomberg U.S. Aggregate Bond Index, respectively).

In assessing what this all means for investors, it's helpful to look at how and when the average American consumer spends, because American consumers comprise nearly 68% to 69% of U.S. gross domestic product as of the third quarter 2021.

Based on data from the Bureau of Economic Analysis, consumers have spent significantly more on durable goods (which include motor vehicles, furniture, appliances, etc.) than on nondurable goods (such as food and beverages, clothing, etc.) every year since 2013. Also, in the year 2020, spending on durable goods outweighed the spending on nondurable goods by a 25% margin (as seen in the following chart).



Source: The U.S. Bureau of Economic Analysis

When the pandemic hit in March 2020, many consumers took advantage of low annual percentage rates to buy new cars and other large ticket items which drove the price of durable goods higher. Continued demand has also contributed to supply chain issues in the durable goods space.

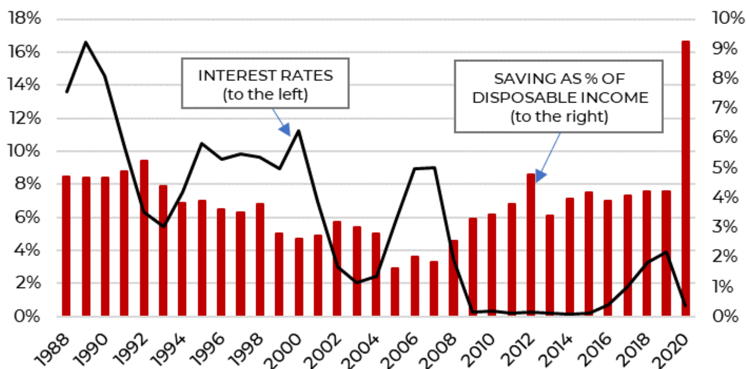
Beyond pure demand, it's important to note that the durable goods space has a much higher barrier to entry, which means that businesses producing these goods aren't easily disrupted and have more pricing power.

Time Period	2-Yr. U.S. Treasuries	Bloomberg U.S. Aggregate Bond Index	Short-term Corporate Bonds	U.S. High Yield Bonds	Russell 1000 Growth	Russell 3000	Russell 1000 Value
3/31/1988 - 2/28/1989	3.88%	5.15%	6.29%	10.76%	11.23%	12.20%	13.60%
2/3/1994 - 2/1/1995	1.14%	-2.05%	1.85%	-1.85%	0.51%	-3.02%	-5.60%
6/30/1999 - 5/16/2000	2.76%	1.59%	3.68%	-2.33%	25.24%	11.54%	-3.39%
6/29/2004 - 6/29/2006	1.70%	2.99%	2.41%	7.40%	4.22%	9.06%	13.38%
12/17/2015 - 12/20/2018	0.64%	1.87%	1.88%	7.40%	10.34%	8.40%	6.63%
AVERAGE RETURN	**2.03%**	**1.91%**	**3.22%**	**4.28%**	**10.31%**	**7.64%**	**4.92%**

Source: Bloomberg Finance, L.P. Past performance is not an indicator of future returns.

Bringing the conversation back to the potential impacts of rising rates, more expensive borrowing costs doesn't necessarily mean that consumers will reduce spending. Historically, we've seen that consumers continue to spend regardless of interest rate hikes and this trend is noticeable when looking at the increase in durable goods consumption throughout the 2015-2018 rate hike.

Because consumers now have a heightened level of personal savings a percentage of their disposable income, we think that their willingness to spend will continue into 2022. Although we think that the increased level of savings will normalize back into the 4-5% range, we believe that the high level of cash still sitting on the sidelines supports a continued bull case for growth stocks as they are propelled by continued consumer spending.



Sources: Bloomberg Finance, L.P. and the U.S. Bureau of Economic Analysis

To recap, growth stocks on average have been shown to outperform value and taxable fixed income during periods of rate hikes. Also, increased spending in the durable goods space coupled with decreases in personal savings may be key economic indicators of future growth. As long as consumers continue to spend and entrepreneurs continue to innovate exciting products, we have a positive view on growth stocks.

Sources: Bloomberg Finance, L.P., Board of Governors of the U.S. Federal Reserve, Federal Reserve Bank of St. Louis, the U.S. Bureau of Economic Analysis.

Index definitions: The 2 Year U.S. Treasuries is represented by the ICE BofA Current 2-Year U.S. Treasury Index (GA02 Index); the Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs, ABS, and CMBS (agency and non-agency) (LBUSTRUU Index); Short-term corporate bonds is represented by the ICE BofA 1-3 Year U.S. Corporate Index, which is a subset of the ICE BofA U.S. Corporate Index including all securities with a remaining term to final maturity of less than 3 years (C1A0 Index); U.S. High Yield Bonds is represented by the ICE BofA U.S. High Yield Index and tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market (H0A0 Index); the Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values (RLG Index); the Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of securities represents approximately 97% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices (RAY Index); the Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values (RLV Index). Past performance is no guarantee of future returns. The S&P 500 Index is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalizations.

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