The end of a cycle?

Key Takeaways

- After 5.5% of interest rate hikes, many investors believe the Fed is near the end of its hiking cycle.
- The long-term investment implications of this are clearly positive in our view.
- Peaking interest rates may imply a slowdown in growth, but they also imply an end to a period of very high inflation – a clear positive for investors.

Long and variable lags

Economics is not a precise science. Central banks attempt to influence the economy through monetary policy (commonly by raising or lowering interest rates). The Fed uses monetary policy to attempt to achieve its dual mandate of price stability (low inflation) and full employment (economic growth). However, monetary policy affects the economy with "long and variable lags" – sometimes raising interest rates slows growth and lowers inflation quickly. Sometimes, it may take years for growth and inflation to slow. Inflation has fallen from 9.1% last year to 3.7% in August. This has led many market participants to believe that the Fed is near the end of its hiking cycle. So, what are the implications for investors?

Hard or soft landing?

The short-term implications of the end of the hiking cycle depend on the near-term direction of growth and inflation. So far, growth has been remarkably resilient. The Atlanta Fed's GDPNow estimates that the economy grew at close to 6% (annually) during August. The labor market remains very strong but is starting to show signs of slowing. This suggests that while the economy is slowing (even potentially into a recession), the slowdown may be mild.

In our view, the bigger question is how quickly inflation will decline to the Fed's 2% target. While inflation has fallen markedly, resilient economic growth suggests the path to the Fed's target may be challenging. This implies potentially modest interest rate cuts, leaving short-term interest rates somewhere north of 4.5%. For shorter-term investors, who are less concerned with reinvestment risk, these levels are very attractive compared to the last ten years.

Longer-term investors may want to consider ensuring their portfolios have sufficient levels of defensive and diversifying assets. For example, high-quality bonds (US Treasuries) offer reasonably high yields (compared to the last ten years) and good diversification benefits relative to equity portfolios.

Stepping back and considering the big picture, we view the end of the hiking cycle as a positive for long-term investors. The end of the hiking cycle implies that this period of extremely high inflation is finally over. Historical analysis shows that long periods of high inflation are incredibly damaging to investors.

Key takeaway

This interest rate hiking cycle aims to lower economic growth, eventually lowering inflation. While the end of the cycle implies an economic slowdown (and maybe a recession), it also implies an end to a period of very high inflation. Long-term, this is a clear positive for investors.

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