
Balanced

February 2022 Edition

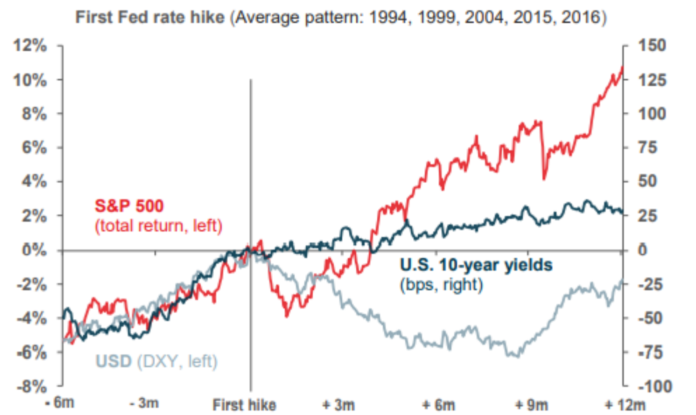
# Interest Rates ~ Laurel Hickey & Garth Bluekens

## Comments from the CIO's office

**Martin Lefebvre is National Bank Investments Chief Investment Officer and Strategist. Please see below for key takeaways from his February Asset Allocation update.**

Starting from the assumption that a new rate-hike cycle is around the corner, we have studied how different asset classes have performed in such circumstances over the last 30 years. The complete study is featured in a strategic report available here[1]. In short, we find that **(1)** the stock market tends to react nervously at the onset of a rate hike cycle, but these concerns quickly dissipate to give way to gains after 12 months, **(2)** 10-year yields tend to rise in the months before the first hike, but not so much thereafter, and **(3)** the U.S. dollar generally peaks as the Fed hikes, depreciating persistently in the following 6 months (chart below). Several parallels between these historical trends and the current environment can be drawn.

**13 | What happens when the Fed starts to hike?**




CIO Office (data via Refinitiv).

For the stock market, it seems that the acclimatization process involving increased volatility is happening ahead of time, not too shocking given the Fed is much more predictable nowadays. Beyond short-term fluctuations, however, sustained earnings growth during the next 12 months should enable gains, as has been the case in each of the 5 historical episodes analyzed. At this juncture, the earnings outlook is for around 10% growth, in line with the historical average. Could the gradual reduction of the Federal Reserve's balance sheet – which is expected to begin sometime this summer after a brief period of reinvestment – complicate matters? There is less historical precedent here. Yet, it is worth noting that balance sheet stabilization/reduction policies have rarely been a dominant factor for markets, except under two conditions: **(1)** following a miscommunication by Fed Chairs such as Bernanke in 2013 and Powell in 2018; and **(2)** when the size of the balance sheet is no longer sufficient to meet the market's liquidity needs, as in 2019. For now, the main risk centres on the Fed's communication strategy, but the institution is clearly seeking to avoid repeating mistakes of the past, stating, for instance, that it intends to reduce its assets "in a predictable manner." We'll see but, for now, this is not a major source of concern.

Finally, one of the most persistent trends throughout the history of rate-hike cycles is the depreciation of the U.S. dollar. This suggests that while the Greenback still has near-term upside potential, it is likely to come down later in the year, possibly just as Chinese economic activity starts to benefit from more accommodative monetary and fiscal policies. If this trend reversal takes hold, it could open an opportunity in emerging markets which tend to do well under such conditions, but the stars do not yet seem to be aligned for the region.

## What's Interest Rates Got To Do With It?

On January 26th the Bank of Canada kept the target for the overnight lending interest rate at 0.25%. The decision to hold rates for now could in part be due to the uncertainty of Omicron and the lower spending in the month of January because of it.[2] Though no changes for now, we know that there is a good chance an increase could still be coming in March. A rising rate environment can sound intimidating because we have not been here in quite a few years. This environment is not ideal if you are looking to borrow, but interest rates are still low on a historical basis. In 2007 before the onset of the largest bull market in history, the prime rate was around 6.00%. The prime rate is different than the overnight lending rate, as this is the rate that sets interest rates for individuals

looking to borrow money. Currently, the prime rate is at 2.45%. Even with the potential of up to 6 rate hikes this year of 25 basis points, this would bring the prime rate to 3.95%.[3]

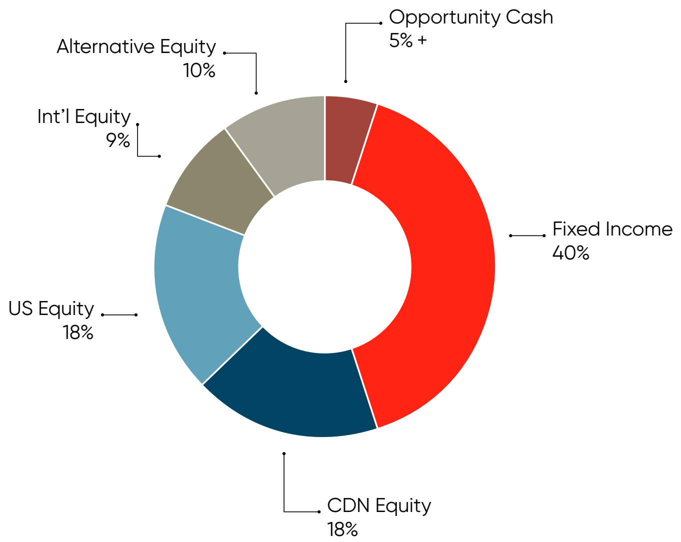
When it comes to equities, as mentioned in the NBI strategic report previously linked, they found that, though conditions during each tightening cycle are different, the few months after a hike can be quite volatile, but by the end of the year returns tend to be positive due to positive earnings growth. We are seeing this right now in the markets, after closing out January down, the market has recovered some of the losses after multiple S&P 500 companies' earnings beat estimates. It is still important to remain cautious as we enter 2022. We are in a very different environment of still dealing with the effects of a pandemic, supply chain disruptions, and geopolitical risks.

[1] strategic-report.pdf (nbinvestments.ca)

[2] Bank of Canada holds interest rates for now, but signals hikes to come - National | Globalnews.ca

[3] What is the prime rate in Canada and what does it mean for you? | Financial Post

## Balanced Investment Model Sleeve Goal Allocation




## Your Investment Policy

BALANCED PROFILE: You give equal importance to achieving growth in your investments and receiving income. You can tolerate moderate changes in market value to ensure growth, but you prefer having a mix of fixed income investments and equities for reasons of stability. If you feel that your risk tolerance is shifting, please let us know!

**Source:** This information is for illustration purposes and subject to change. Your portfolio may not hold all of these positions. We enhance the composition of your portfolio with additional equity solutions that are not illustrated. The weightings change with market fluctuations and model rebalancing.


Laurel Marie Hickey CFP® CIM® FCSI®
Wealth Advisor & Portfolio Manager
239 8th Avenue SW Calgary Alberta T2P 1B9

Garth Bluekens CPA CA PFP® CIM®
Senior Wealth Advisor & Portfolio Manager
404 6th Street S Lethbridge Alberta T1J 2C9

**Tel.:** 403-531-8429 | **Toll Free:** 1-877-506-7900 | **Email:** laurel.hickey@nbc.ca