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Post liftoff investing:

Adapting to a hawkish Fed

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For more than a decade, investors have enjoyed supportive financial conditions. The Federal Reserve (Fed) has provided clear forward guidance, their balance sheet has expanded, and interest rates have remained low. For businesses, this has been an era of easy money for new projects, expansion, and mergers and acquisitions (M&A). For everyday individuals, rates on mortgages and personal loans have been attractive, boosting home prices and debt levels. All in all, this has driven a long period of steady economic growth and healthy returns.

However, with the Fed now raising policy rates, inflation at multi-decade highs, and renewed geopolitical risks, investors will need to adjust to tighter financial conditions. Not only could this affect economic growth rates as the cost of borrowing rises, but it could also directly impact market valuations. If (or when) this occurs, there will be less room for error and a greater need for investment discipline in the years to come.

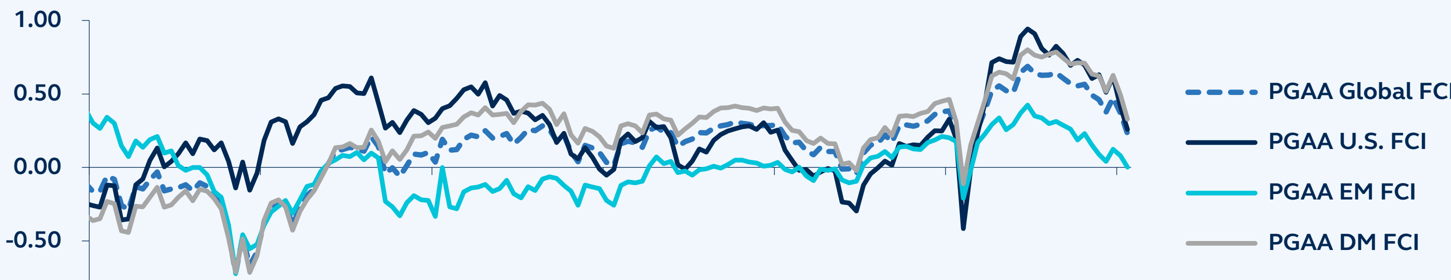
Changing winds

While investing is never easy, the reality is that investors, consumers, and businesses have benefited from significant monetary tailwinds over the past few decades. Since 1990, the 10-year Treasury yield has fallen from as high as 9% to as low as 0.5% and has averaged only 2.25% since 2009. The Fed has kept policy rates low by historical standards over these years, especially the periods of zero-interest rate policy from 2008 to 2015, and 2020 through to the March 2022 Federal Open Market Committee (FOMC) meeting. Even then, when the Fed did raise rates, it did so in a slow and steady fashion, easing investors into the tighter regime.

These financial conditions have greatly supported equity and fixed income valuations across cycles. Except during the initial pandemic lockdowns, broad equity valuations have been rising steadily, from a price-to-earnings ratio as low as 9.5x during the global financial crisis to a vertigo-inducing 19x today. For much of the last cycle, rising valuations helped to boost stock prices, providing investors with healthy returns. From 2009 to 2021, the S&P 500 experienced double-digit returns 10 out of 13 years and was in the red only once. Of course, financial conditions and interest rates were not the only drivers of these returns, but they certainly didn't hurt.

After an influx pandemic-induced supportive policy, financial conditions are rapidly coming back to earth

PGAA Financial Conditions Index (FCI), Z-score, January 2010 – present

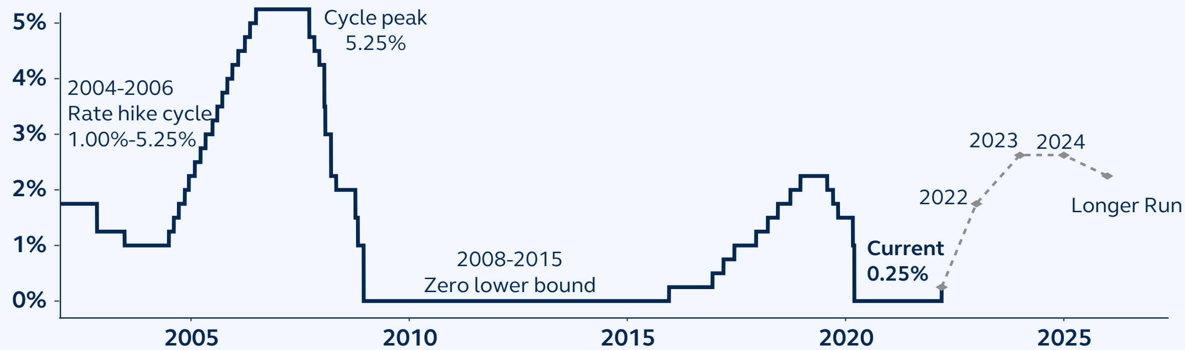


Source: Bloomberg, Principal Global Asset Allocation. Data as of February 28, 2022.

Similarly, fixed income experienced a strong decade, also rising 10 of the past 13 years. Not only did ever-lower interest rates boost bond prices, but this lower-for-longer environment forced investors to "reach for yield" which supported areas such as high yield bonds and emerging market debt. Even when bonds faced rising interest rates, these periods tended to be short-lived.

The Fed has begun raising rates—the first time since 2018

Federal funds rate since 2004 and FOMC projections



Source: Clearnomics, Federal Reserve, Principal Global Investors. Data as of March 16, 2022.

Fed liftoff

This environment, however, is poised to change. With inflation running at a 40-year high, inflation expectations at their highest level in 17 years, labor markets at maximum employment, and rapidly driving fears of a wage/price spiral, the Fed is desperately behind the inflation curve and needs to slam the monetary brakes. In fact, except for 1980, inflation has never been so high at the point of Fed lift-off as it is today—and in the 1980 episode, the Fed raised policy rates by 600 basis points in the first year alone.

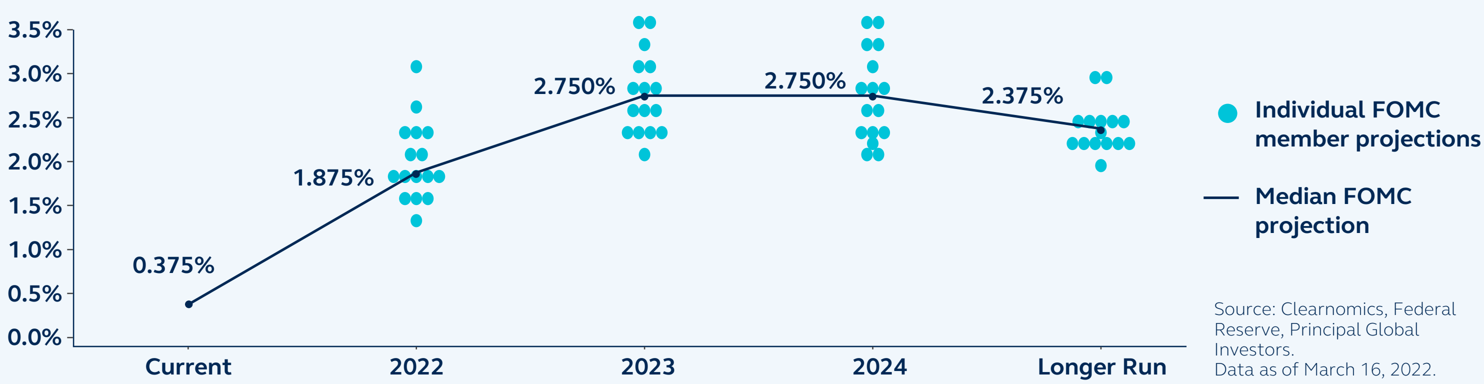
Consider that, going into the pandemic, the federal funds rate had been progressively cut from 2.25% to 1.5%, before being slashed to zero as COVID hit the global economy.

It would take the Fed six hikes to take the fed funds rate back to its pre-pandemic level—and that's before even considering the additional price pressures facing the United States economy today. Pre-pandemic annual Consumer Price Index (CPI) inflation was near 2.4%, broadly in-line with the Fed's target and less than a third of the current level.

As such, the Fed's hike in March is just the first in a line of back-to-back rate increases this year. The Fed's own dot plot depicts a further six hikes over the remainder of the year (coincidentally taking the Fed Funds rate back to just above its pre-pandemic level), followed by further increases in 2023. We are at the beginning stages of a long monetary tightening journey.

Fed officials expect seven total rate hikes in 2022

FOMC member projections & median projection for the federal funds rate



Source: Clearnomics, Federal Reserve, Principal Global Investors. Data as of March 16, 2022.

In addition to policy rates, the Fed will soon begin shrinking its balance sheet after it expanded to nearly $9 trillion in response to the pandemic. During the aftermath of the 2008 financial crisis, the Fed's balance sheet reached $4.5 trillion before the tapering process. Before this, total asset levels had been below $1 trillion. Thus, the Fed's balance sheet "run off" will drain liquidity, likely serving to raise rates across the yield curve and tighten financial conditions even further.

Of course, much can happen between now and then to alter policy expectations—in particular, the conflict in Europe. Many investors are concerned that elevated energy and food prices will soon begin to weigh heavily on consumer sentiment and wallets, prompting a meaningful slowdown in economic growth. This is certainly a risk and one that increases as the duration and intensity of the conflict extends. But, with inflation sitting at 7.9% and threatening to move higher because of the surge in commodity prices, only a looming recession would compel the Fed to halt monetary tightening. Unfortunately, by not addressing inflation earlier, the Fed now needs to prioritize price stability—even in the face of softening growth and geopolitically-driven market turmoil.

Less room to maneuver

The Fed's policy changes could bring about headwinds for global markets, asset classes, and sectors, as the rising tide that has lifted all boats over the past decade is removed.

Without easy financial conditions, earnings growth will be key to risk returns. When economic growth is robust and financial conditions are loose, the market can comfortably grow into lofty multiples. In the future, however, tighter conditions may make it more difficult to satisfy high expectations.

There will be more dispersion, more winners and losers and, as the margin of error shrinks, investors may need to be more disciplined, selective, and thoughtful in their approach.

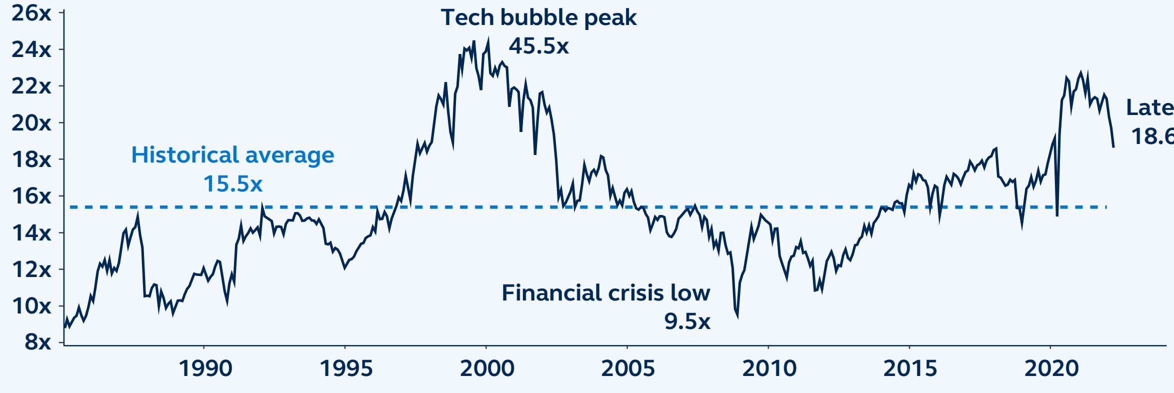
Recently, market valuations have fallen in reaction to the Fed and geopolitics. However, they remain near their highest levels since the dot-com boom. This is especially true among growth and tech stocks which performed extremely well during the post-pandemic recovery. For example, while the price-to-book for the Russell Growth index has fallen, it is still 6.5 multiple points higher than that of the Russell Value index.

The flip side of strong stock returns over the past decade has been that volatility has been relatively benign. With the Fed using its balance sheet to create indiscriminately easy financial conditions for the past ten years, the S&P 500 has experienced few pullbacks. Consider that, except for 2018, when trade wars were a concern and 2020, during the pandemic, the S&P 500 averaged just two 5% pullbacks a year. However, the last decade is the exception, not the rule. Historically, there have been an average of four to five market pullbacks of 5% or worse each year—a scenario that investors will likely need to reacquaint themselves with.

That said, markets typically recovered from these pullbacks within a few weeks or months. Furthermore, equities typically struggle in the first few months of Fed tightening but, after the initial period of digestion, they refocus on corporate profit and earnings dynamics and resume their (admittedly bumpier) upward trend. Thus, tighter conditions in no way imply that the business cycle cannot continue at a healthy pace, but investors will need to be more careful and thoughtful in the years ahead.

Market valuations have steadily risen over the past decade

S&P 500 forward price-to-earnings ratio, next-twelve-months, January 1985 – present



Source: Clearnomics, Standard & Poor's, Refinitiv, Principal Global Investors.
Data as of March 17, 2022.

What can investors do to prepare?

First, a focus on the Quality factor can help to mitigate risk by focusing on companies with attractive attributes and fundamentals. Historically, Quality factors performed well during periods of slowing growth and worsening market conditions, since they typically represent companies with stronger balance sheets, cash flow generation, profitability, and more reasonable valuations. Furthermore, in this period of elevated inflation, there will be greater pressure on margins, and pricing power will become a particularly valuable distinguishing feature of companies.

Second, the transition to tighter financial conditions may benefit U.S. companies over those in Europe. U.S.-based companies should be better positioned to absorb and manage higher interest rates, while continuing to maintain margins despite softer economic growth. Europe's heavy dependence on energy imports—particularly from Russia—implies that food price and goods inflation will be more sensitive to the conflict. Additionally, expect that financial conditions will likely tighten more in Europe, weighing heavily on the European economy and investment performance.

Past-the-peak investing means that investors can no longer rely on easy financial conditions, or accommodative Fed policy. Without the tailwinds of near-zero policy rates, profit margins, balance sheet strength, pricing power and secular growth dynamics will once again dictate market trends. Earnings growth in particular will be key to investment gains.

In this new but once-familiar environment, investors will need to brace for more volatility, adopt a more analytical approach, and be sufficiently nimble to take advantage of opportunities as they arise. Central banks are taking a back seat; now it's time for investors to do the hard work.

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Risk considerations

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