SEVENS REPORT

# Sevens Report Alpha Webinar – How Far Are We Really from the End of Rate Hikes?

## March 2nd, 2023


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# How Far Are We From the End of Rate Hikes?

- Rate hike expectations have driven the markets for over a year.
- When investors think the Fed is close to done, stocks rally. When investors think the Fed is not close to done, stocks fall.
- So, I want to compare this hiking cycle to others to see if the Fed is as close to done as markets think.

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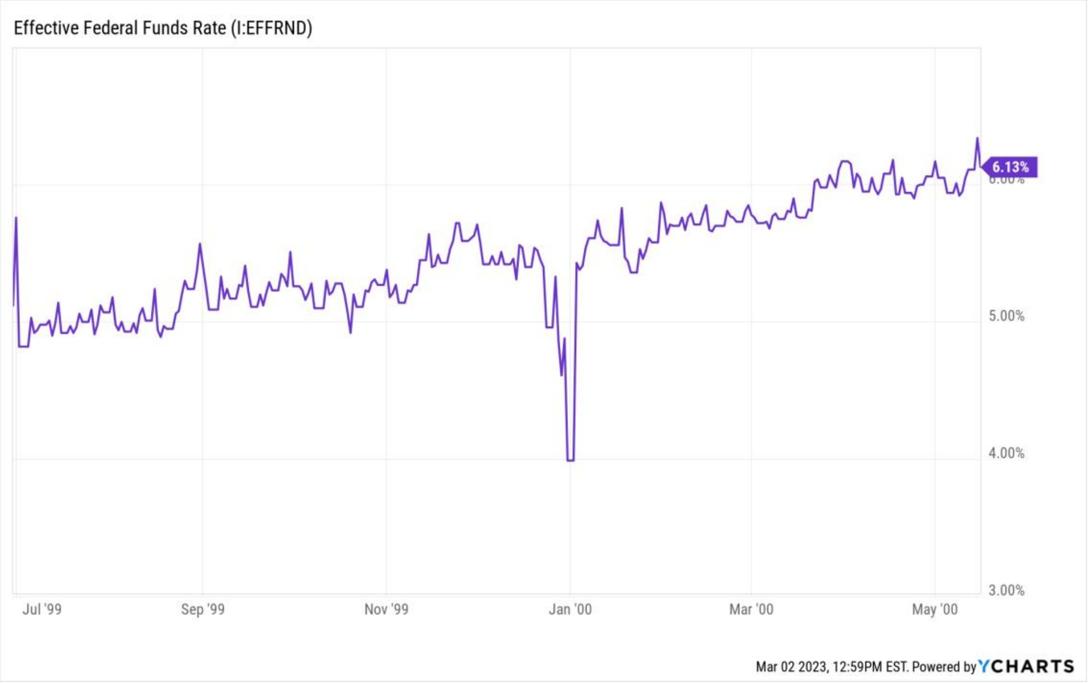
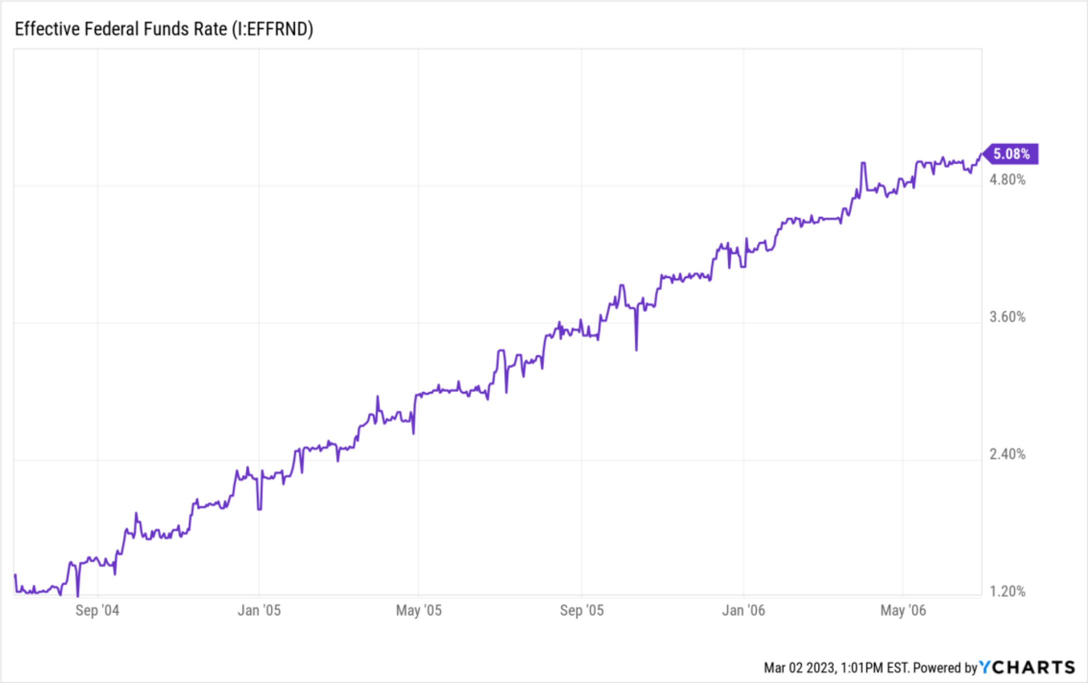
# Early 2000’s Rate Hikes– Last Hike 5/16/2000

- Terminal rate: 6.50%
- Duration: 11 months
- Size of hikes: 175 bps.
- Real Interest Rates: 3.36%
- Core CPI: 2.38%
  - Core CPI Move: 1.96% - 2.38%.
- Core PCE Price Index: 1.72%
- UE Rate: 4.00%
  - UE Rate decline: -0.30%
- ISM Manufacturing PMI: 53.2
  - ISM Manufacturing PMI Decline: -2.6 points.



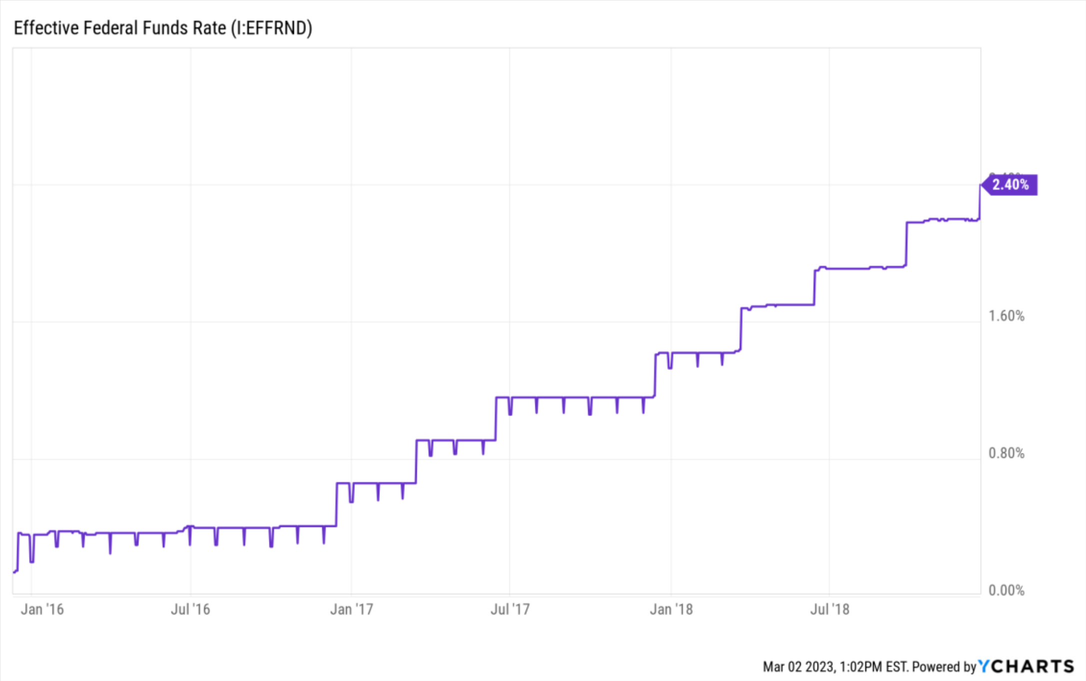
# Mid 2000's Rate Hikes– Last Hike 6/29/2006

- Terminal rate: 5.25%
- Duration:  24 months
- Size of hikes:  425 bps.
- Real Interest Rates:  2.45%
- Core CPI: 2.64
  - Core CPI Move:  1.87% - 2.64%.
- Core PCE Price Index:  2.60%
- UE Rate:  4.60%
  - UE Rate decline:  -1.00%
- ISM Manufacturing PMI:  52.4
  - ISM Manufacturing PMI Decline: 6.30 points.



# Late 2010's Rate Hikes:  Last Hike 12/20/18

- Terminal rate: 2.50%
- Duration:  36 months
- Size of hikes:  225 bps.
- Real Interest Rates:  1.25%
- Core CPI: 2.19%
    - Core CPI Move:  2.07% - 2.19%.
- Core PCE Price Index:  2.08%
- UE Rate:  3.90%
    - UE Rate decline:  -1.1%
- ISM Manufacturing PMI:  54.30
    - ISM Manufacturing PMI Move: +6.30 points.



# Then vs. Now

| | Late 1990's | Mid 2000's | Late 2010's | Now |
|---|---|---|---|---|
| Terminal Rate | 6.50% | 5.25% | 2.50% | **4.625%** |
| Real Interest Rate | 3.36 | 2.45 | 1.25 | **1.40** |
| Size of Hike Campaign | 175 bps | 425 bps | 225 bps | **450 bps** |
| Core CPI | 2.38% | 2.64% | 2.19% | **5.55%** |
| Core PCE PI | 1.72% | 2.60% | 2.08% | **4.71%** |
| UE Rate | 4.00% | 4.60% | 3.90% | **3.40%** |

# Thoughts

- I don't think the late 2010's hikes are a good comparison to now, because it was a different era in inflation.
- Observations:
  - The terminal rate isn't as high as it was at previous peaks.
  - Real interest rates aren't as high as they were at previous peaks.
  - Inflation is higher than it was (meaning more hikes may be needed)
  - The Unemployment rate is lower (meaning more hikes may be needed).

| | Late 1990's | Mid 2000's | Now |
|---|---|---|---|
| Terminal Rate | 6.50% | 5.25% | 4.625% |
| Real Interest Rate | 3.36 | 2.45 | 1.40 |
| Size of Hike Campaign | 175 bps | 425 bps | 450 bps |
| Core CPI | 2.38% | 2.64% | 5.55% |
| Core PCE PI | 1.72% | 2.60% | 4.71% |
| UE Rate | 4.00% | 4.60% | 3.40% |

# So, What’s It Mean?

- Rates need to go higher than the 5.125% expectation.
- Currently, terminal Fed Funds expectations is about 5.625%. That’s 100 bps higher than current levels.
- That would put the peak Fed funds rate in line with previous cycle highs.
- Given low unemployment and high inflation, however, rate hikes to 6.00% or higher can’t be ruled out.

# Practical Market Implications

- Risk for rates remains higher, not lower.
  - That means growth, tech, and high multiple sectors should remain volatile while value, low multiple, and RSP should outperform over the longer term.
  - Broadly, it also means that any rallies will likely be temporary, because stocks will not be able to bottom until they know when the Fed is "done" with rate hikes (and even that might not be the bottom depending on the economic damage).
- That said, the bond market has dramatically re-priced rates over the past month, and the drop in stocks hasn't been too bad.
  - That resilience, if it lasts, implies the stock market has priced in rate hikes, which could be a powerful positive in the coming months.
- So, when will the Fed stop?
  - **My thought: 5.375% in June. This is a contrarian view.**
  - Why:
    - The Fed is cognizant of previous rate hikes and dis-inflation is occurring. They won't want to hike much more given past actions.
    - No one at the Fed is materially guiding expectations higher, and as such I see the dots rising only slightly.
    - I continue to expect growth to slow in the coming months, evoking a "wait and see" approach for markets.
  - Does this market me bullish here? No. We could easily see expectations for rate hikes rise further before reversing.