Market Perspective – Rising yields and less Fed accommodation to inject volatility but history suggests primary market trend remains higher

Keith Lerner, CFA, CMT
Co-Chief Investment Officer
Chief Market Strategist

Shelly Simpson, CFA, CAIA
Senior Investment Strategy Analyst
Portfolio & Market Strategy

January 6, 2022

What happened

After a strong start to the year, volatility in markets has risen. Investors appear concerned that the Federal Reserve (Fed) may reduce policy accommodation at a faster rate than previously expected. At the same time, the 10-year U.S. Treasury yield has jumped from a low of 1.35% in late December to above 1.70% for the first time since April 2021.

Our take

A shift in **Fed policy often injects volatility into markets**. Indeed, this is one of the key points we discussed in our 2022 outlook and is a reason behind why **we are looking for more moderate market returns and more normal pullbacks**.

That said, **stocks have generally had positive performance during periods where the Fed is raising short-term rates because this is normally paired with a healthy economy**. A growing economy supports corporate profit growth, which supports the stock market.

Moreover, with U.S. GDP output above pre-pandemic levels, annual job gains in 2021 at a record level, and inflation well above average, **it's hard to justify maximum monetary policy accommodation when the economy is no longer in crisis**.

However, **it will be a long time before one could argue that Fed policy is restrictive**, especially when one considers that yields after inflation, known as real yields, remain in deeply-negative territory. This stands in sharp contrast to 2018, when markets had a sharp selloff late in the year when real yields were slightly positive and investors were concerned the Fed was becoming too aggressive.

Notably, stocks have risen at an average annualized rate of 9% during the 12 Fed rate hike cycles since the 1950s and showed positive returns in 11 of those instances. The one exception was the 1972-1974 period, which coincided with the 1973-1975 recession. Our work suggests near-term recession risks remain low.

Likewise, stocks have generally risen during periods of rising 10-year U.S. Treasury yields. **In a study of 15 periods where intermediate rates rose by at least 1.5 percentage points since 1950, stocks averaged an annualized gain of 12%**. The exceptions have coincided with recessions or economic slowdowns.

Importantly, **intermediate-term rates are only back to pre-pandemic levels**. This is certainly justified in our view given the aforementioned economic and inflation backdrop. It's also consistent with our fixed income team's outlook for higher rates and higher volatility.

Even with the recent rise in 10-year yields and stocks, **the equity risk premium,** a metric that compares the valuation of stocks to bonds, **remains at a level that has historically corresponded with stocks outperforming bonds on a 12-month basis by an average of almost 11%.** Accordingly, we do not see the current level of the 10-year U.S. Treasury yield as a significant threat to the bull market.

Bottom line

A shift in Fed policy and rising interest rates are expected to continue to inject volatility into markets. Arguably, sensitivity to a shift is higher than normal given the large role monetary stimulus played in the recovery. Still, it's important to note that this shift is occurring against a healthy economic backdrop. History strongly suggests that markets can rise even in the face of higher short- and intermediate-term rates, and at current levels, they remain far from restrictive.

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Fed rate hikes likely to inject volatility into the market, but stocks tend to outperform fixed income during tightening cycles

Equities have generally had positive performance during periods where the Fed funds rate is rising because this is normally paired with a healthy economy and rising profits.

Stocks have risen at an average annualized rate of 9.4% during the 12 Fed rate hike cycles since the 1950s and showed positive returns in 11 of those instances.

The one exception was the 1972-1974 period, which coincided with the 1973-1975 recession. We view near-term recession risks as low.

		Annualized returns for periods greater than 12 months				
Periods of rising Fed funds rate		U.S. large cap equity (%)	U.S. small cap equity (%)	U.S. intermediate-term government bonds (%)	U.S. long-term government bonds (%)	Core taxable bonds (%)
8/1954	10/1957	13.7	10.9	0.1	-2.5	
6/1958	11/1959	24.5	31.6	-3.2	-6.4	
8/1961	11/1966	7.0	12.7	2.9	2.2	
8/1967	8/1969	3.7	12.4	2.7	-2.6	
3/1972	7/1974	-8.6	-19.4	2.3	-0.4	
2/1977	6/1981	11.5	34.9	3.7	-1.4	2.5
3/1983	8/1984	13.2	12.3	5.9	1.7	6.5
1/1987	5/1989	16.2	11.1	6.1	5.7	6.9
2/1994	2/1995	4.1	2.2	-2.3	-4.6	0.0
6/1999	5/2000	10.5	20.7	3.1	3.7	2.1
6/2004	6/2006	8.2	13.5	1.8	5.4	3.1
12/2015	12/2018	8.4	5.4	1.5	2.3	1.9
Average		**9.4**	**12.4**	**2.1**	**0.3**	**3.3**

Data Source: Truist IAG, Morningstar, Haver. Total return analysis is used. Core taxable bonds = Bloomberg U.S. Aggregate, U.S. large cap = S&P 500, U.S. small cap = IA SBBI U.S. Small Stock, U.S. intermediate-term government bonds = IA SBBI U.S. IT Govt, U.S. long-term government bonds = IA SBBI U.S. LT Govt.

Rising Fed rate periods constructed using the Federal funds effective monthly average rate from 1954 – 1981; thereafter, the Fed funds target rate is used. Past performance does not guarantee future results.

Periods of rising 10-year Treasury yields are generally positive for equities

Stocks have generally risen during periods of rising 10-year U.S. Treasury yields. In a study of 15 periods where intermediate rates rose by at least 1.5 percentage points, the S&P 500 rose at an average annualized gain of 12.3%. The exceptions in this study, where markets did not rise, have coincided with recessions or slowdowns.

Periods of rising 10-year Treasury yield		10-year Treasury yield (%)			S&P 500 (%)	
		Starting	Ending	Change	Return (Annualized)	Return (Cumulative)
5/1954	10/1957	2.3	4.0	1.7	16.0	67.9
5/1958	1/1960	2.9	4.7	1.8	19.1	35.8
6/1961	8/1966	3.7	5.4	1.7	6.2	36.9
4/1967	5/1970	4.5	8.0	3.5	-2.0	-6.1
4/1971	9/1975	5.5	8.5	3.0	-0.4	-1.8
1/1977	2/1980	6.8	12.7	5.9	7.2	24.6
7/1980	9/1981	10.1	15.8	5.8	6.6	8.3
5/1983	5/1984	10.3	13.9	3.6	-3.6	-3.9
9/1986	9/1987	7.0	9.6	2.7	28.8	31.6
10/1993	11/1994	5.4	7.9	2.5	1.8	2.2
10/1998	1/2000	4.4	6.7	2.2	28.3	39.4
6/2003	6/2006	3.4	5.2	1.8	11.4	39.3
1/2009	12/2009	2.3	3.9	1.6	26.5	26.5
8/2012	12/2013	1.5	3.0	1.5	25.7	38.3
8/2016	10/2018	1.5	3.2	1.7	12.6	30.5
Average		**4.8**	**7.5**	**2.7**	**12.3**	**24.6**

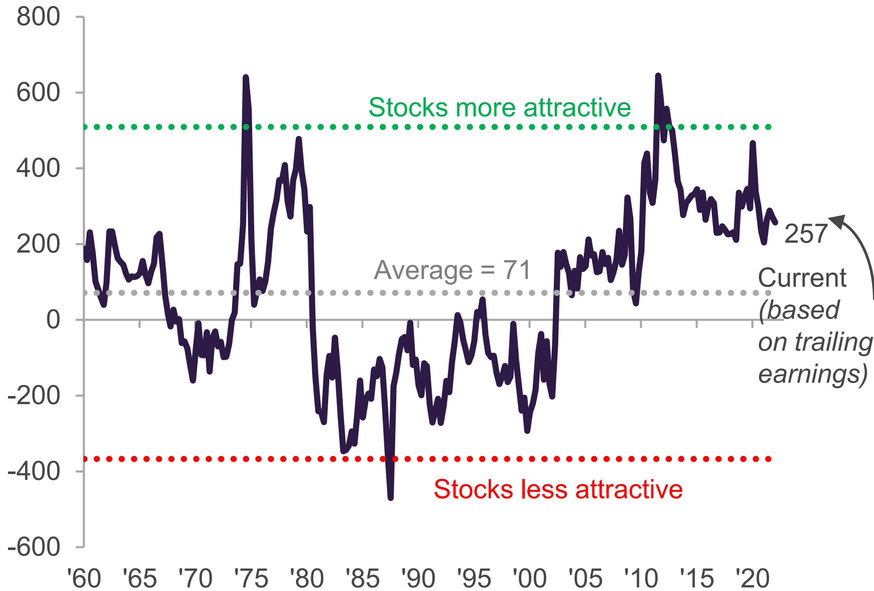
Data Source: Truist IAG, Haver, Morningstar. Total return analysis is used.

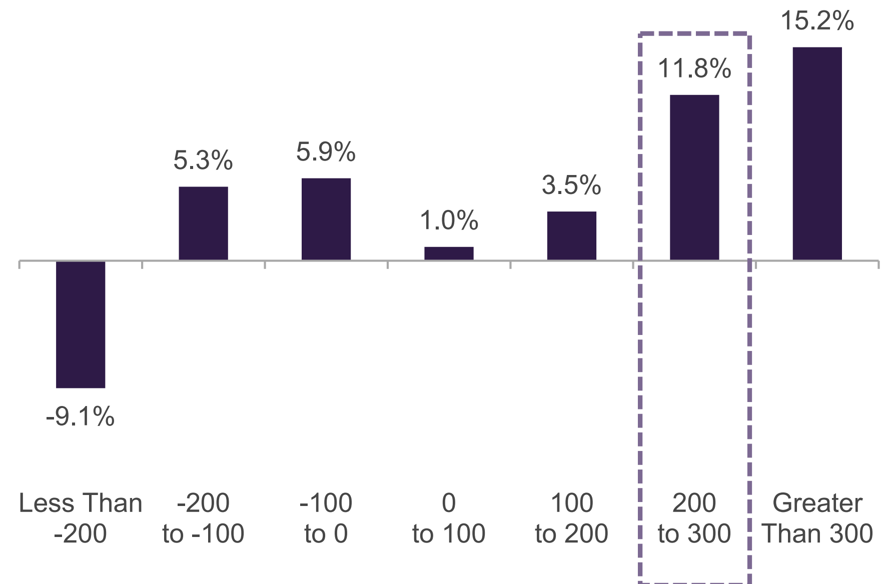
Prior to 1962, the 10-year Treasury yield is constructed using the monthly average; thereafter, the month end value is used.

Note: Periods assume at least a 150 basis point rise in the yield. Past performance does not guarantee future results.

Stocks still appear attractive on a relative basis

Even with the recent rise in interest rates and stocks, the equity risk premium, a metric that compares the valuation of stocks to bonds, remains at a level that has historically corresponded with stocks outperforming bonds on a 12-month basis.

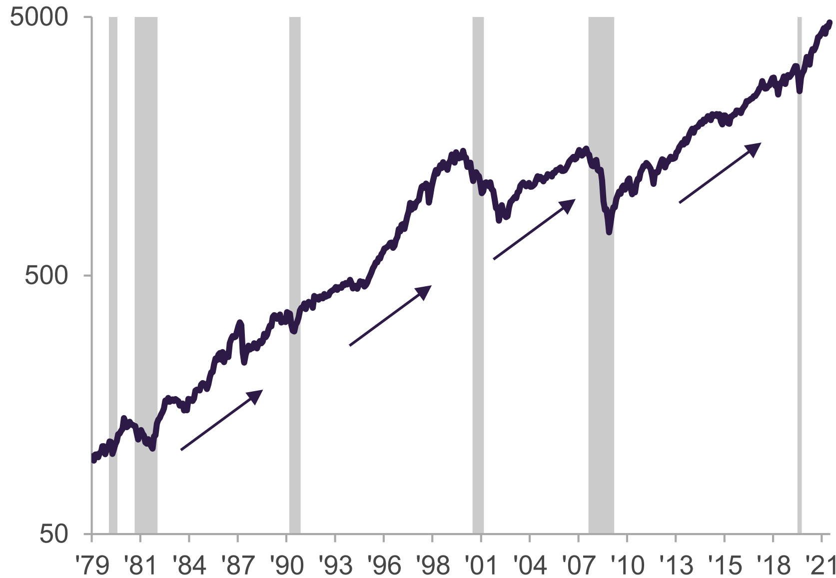


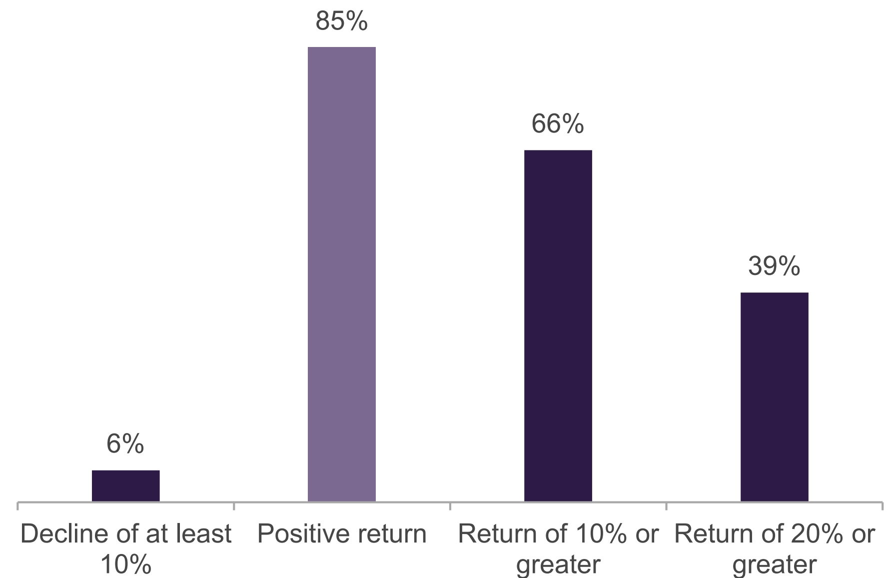


Data Source: Truist IAG, Haver, Morningstar, FactSet. Past performance does not guarantee future results.
*The equity risk premium (ERP) compares the earnings yield of stocks (inverse of the P/E ratio) to the 10-year U.S. Treasury yield. ERP is quantified in basis points (bps). One basis point = 0.01%.

Stocks have risen 85% of the time during economic expansions

Even with higher rates, we still view near-term recession risk as low, and that's a positive given stocks have tended to rise when the economy is growing. Indeed, the average economic expansion since WWII has lasted more than five years compared to the current recovery of less than two years. And, a stronger economy helps corporate profits, which should support the stock market.





Data Source: Truist IAG, Haver, Morningstar; Right chart study covers period since 1927 and is based on rolling one-year total returns. Past performance does not guarantee future results.

Expect markets to have deeper and more normal corrections in 2022

Stocks posted abnormally strong returns alongside abnormally shallow pullbacks over the past year. The deepest intra-year pullback for the S&P 500 in 2021 was just 5% versus an average of 14% since 1950.

Following the 10 calendar years with the shallowest pullbacks, stocks tended to rise the next year but were more volatile – the S&P 500's deepest intra-year pullback averaged 13% (9% median) while posting an average total return of 7% (median 10%).

Beyond the numbers, a shift in Fed policy is also among the key reasons we expect more normal pullbacks this year.

S&P 500 drawdowns and returns in years following shallow pullbacks

Year with shallow drawdown			Following year		
Year	Largest intra-year pullback	Calendar year total return	Year	Largest intra-Year pullback	Calendar year total return
1995	-3%	37%	1996	-8%	23%
2017	-3%	22%	2018	-20%	-4%
1964	-4%	16%	1965	-10%	12%
1958	-4%	43%	1959	-9%	12%
1954	-4%	53%	1955	-11%	32%
1961	-4%	27%	1962	-27%	-9%
1993	-5%	10%	1994	-9%	1%
1972	-5%	19%	1973	-23%	-15%
1991	-6%	31%	1992	-6%	8%
2013	-6%	32%	2014	-7%	14%
2021	-5%	29%		?	?
***Average**	**-4%**	**29%**		**-13%**	**7%**
***Median**	**-4%**	**29%**		**-9%**	**10%**

Data Source: FactSet, Truist IAG

Past performance does not guarantee future results

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Equity is represented by the MSCI ACWI captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries*. With 2,757 constituents, the index covers approximately 85% of the global investable equity opportunity set

Fixed Income is represented by the Barclays Aggregate Index. The index measures the performance of the U.S. investment grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.

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Commodities are represented by the Bloomberg Commodity Index which is a composition of futures contracts on physical commodities. It currently includes a diversified mix of commodities in five sectors including energy, agriculture, industrial metals, precious metals and livestock. The weightings of the commodities are calculated in accordance with rules that ensure that the relative proportion of each of the underlying individual commodities reflects its global economic significance and market liquidity.

Cash is represented by the ICE BofAML U.S. Treasury Bill 3 Month Index which is a subset of the ICE BofAML 0-1 Year U.S. Treasury Index including all securities with a remaining term to final maturity less than 3 months.

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U.S. Mid Cap is represented by the S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, measures the performance of mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

U.S. Small Cap Core Equity is represented by the S&P 600 Small Cap Index which is a measure of the performance of the small-cap segment of the U.S. equity universe

International Developed Markets is represented by the MSCI EAFE Index is an equity index which captures large and mid cap representation across 21 Developed Markets countries* around the world, excluding the U.S. and Canada. With 921 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Emerging Markets is represented by the MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries*. With 1,125 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Value is represented by the S&P 500 Value Index which is a subset of stocks in the S&P 500 that have the properties of value stocks.

Growth is represented by the S&P 500 Growth Index which is a subset of stocks in the S&P 500 that have the properties of growth stocks.

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U.S. Investment Grade Corporate Bonds are represented by the Bloomberg U.S. Corporate Investment Grade Index which is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least $250 million par amount outstanding.

The S&P U.S. REIT index measures the investable universe of publicly traded real estate investment trusts domiciled in the United States

U.S. High Yield Corp is represented by the ICE BofAML U.S. High Yield Index tracks the performance of below investment grade, but not in default, U.S. dollar denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody’s and S&P.

Floating Rate Bank Loans are represented by the Credit Suisse Leveraged Loan Index. The index represents tradable, senior-secured, U.S.-dollar-denominated non-investment-grade loans.

Global Equity is represented by the MSCI All World Country (ACWI) Index which is defined as a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI Index consists of 48 country indices comprising 24 developed markets countries and 24 emerging markets countries.

Emerging Markets Equity is represented by the MSCI EM Index which is defined as a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets countries

Intermediate Term Municipal Bonds are represented by the Bloomberg Municipal Bond Blend 1-15 Year (1-17 Yr) is an unmanaged index of municipal bonds with a minimum credit rating of at least Baa, issued as part of a deal of at least $50 million, that have a maturity value of at least $5 million and a maturity range of 12 to 17 years.

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Slide 50 – EU Corporate is represented by the Bloomberg Euro-Aggregate Corporates Index which is a benchmark that measures the corporate component of the Euro Aggregate Index and includes investment grade, euro-denominated, fixed-rate securities.

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CN2022-0036 EXP01-2023

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