Homestead Funds | Homestead Advisers

2024 Market Outlook

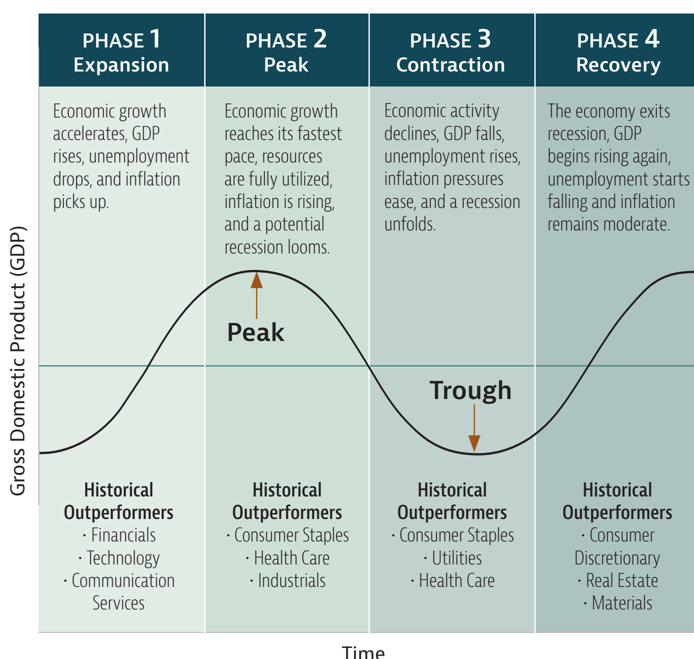
As a More 'Traditional' Economic Cycle Returns, Investment Dynamics Are Shifting

After a 15-year hiatus, the traditional relationship between inflation, interest rates and the economic cycle is reemerging. This backdrop has repriced markets and shifted investment dynamics across stocks and bonds. Here's what we believe investors need to know as they navigate the return to a more traditional economic cycle.

Looking Back to a Similar Rate Environment; Lessons Learned From the 1980s-1990s

The current rate environment may raise concerns for investors who came of age during the near-zero interest rate environment we experienced over the past decade. However, overnight federal fund rates have historically been in the same 3%-6% range that we have seen from late 2022 through 2023 to date. If we look back to the early 1980s, double-digit inflation required a similar aggressive Federal Reserve tightening cycle, which created, from the mid-1980s through the 1990s, a more "traditional" economic environment compared with the ultra-low interest rate environment that has persisted since the 2007-2009 financial crisis.

A Traditional Cycle of Growth, Inflation and Interest Rates



A brief history lesson. With inflation spiraling over 10% in 1979, then-Federal Reserve Chair Paul Volcker raised the fed funds rate to unprecedented levels, peaking above 19% in 1981. As a result, the economy experienced back-to-back recessions. However, with this aggressive tightening campaign, the Fed succeeded in moderating inflation and was then able to reverse course and reduce interest rates over the next several quarters, providing stimulus to the slowing economy.

Where we are today. In contrast to the post-financial crisis, where the fed funds rate remained near zero, the post-COVID-19 reopening of the economy has fueled price inflation and required an aggressive Federal Reserve action similar to the early 1980s. Trying to mitigate spiraling inflation in 2021-2022, which peaked at around 9% in June 2022, Federal Reserve Chair Jerome Powell has embarked on a tightening policy where fed funds now are between 5.25% and 5.50% from near zero. While high by recent standards, 5.25% is in the "normal" overnight range and mild compared with Volcker's actions. This return to "normalcy" suggests that the Fed may continue to leave rates at these levels to temper the economy and subdue inflation, but it may begin to reduce rates if the economy slows, similar to the 1980s but within the normal band of a similar market cycle of 3%-6%.

Here are a few things that we believe you can expect. Elevated rates in a more normal environment will likely bring increased volatility. For stocks, investors should expect a shift from high-growth stocks toward value, which could reward strong fundamentals over momentum. Bond prices will remain pressured in the short term until inflation stabilizes and rate hikes conclude. However, higher yields across bonds will give risk-averse investors alternatives to dividends and growth for the first time in over a decade. While we can't predict the future, historical trends indicate that markets tend to evolve and recover from setbacks when fundamentals are sound.

Economy: A Slowdown Is the Expected Result of Rate Hikes

An economic slowdown of some form is still in the cards, we believe. How much will the economy slow down? That's a matter of degree — and one that is not fully predictable. As a conservative team, we tend to take the view that the Federal Reserve has moved sharply higher in a short period of time and that action will drive a commensurate reaction. We also

believe the Fed waited too long to begin tackling inflation, and because of that it will have to continue treating inflation for a longer period as well, forcing a harsher impact on the economy in the long run.

Stocks: Growth Is No Longer the Only Option

In the near-zero-interest-rate years following the financial crisis, growth stocks were often the top performers. Slower-growth companies just couldn't compete on stock performance in a market environment where the cost of capital was practically free and the highly valued metric was growth.

The Fed's near-zero interest rate policy of 2008 to 2015 was an unprecedented experiment for interest rates, which we believe had a significant effect on all asset values, including stocks. With a return to a more traditional interest rate environment, we think the stage could be set for a broader market than just a select group of top growth names, particularly technology stocks. This normalized rate environment could lead to more traditional value and non-technology stocks also working. In this environment, portfolio managers have the ability to allocate across sector, providing the potential to deliver better performance. Based on historical performance, stocks have been a suitable option for portfolio growth greater than the rate of inflation.

Has your portfolio kept pace with the return of the economic cycle? We are here to help. Reach out to our team anytime to talk about your investments.

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Bonds: Yield Is Back, Baby

Not too long ago, the market mantra was "TINA" — "there is no alternative." There was no alternative to stocks, in other words, because bonds and other interest-rate-driven investments were yielding almost nothing to investors. Indeed, the decade post the financial crisis, many dividend-paying stocks had higher yields than some U.S. Treasuries!

But now, with the return of a traditional economic cycle, the world is right side up again. Bond yields are higher than stock yields, and bonds can once again resume their rightful role in portfolios. For conservative investors who need to preserve wealth, bonds are an option to store value with the goal of generating some return. For more moderate or growth-oriented investors, bonds still come into play as a supporting actor in portfolios, providing steady coupon income to buffer the ups and downs of the stock allocation. For institutions, a much broader menu of fixed-income options are available to help with balance sheet obligations across maturities.

Inflation has not been a pleasant experience in many respects, and the rate-hike cycle brings its own friction points. But the return to normalcy has been a welcome one in the bond world, where the full menu of investment options is once again useful to savers and investors.

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