Tacking Into The Wind

Of all of the things one can do "into the wind," tacking is perhaps the most genteel and useful. Investors face the same conundrum; our tasks are far easier with the wind at our backs than in our faces, yet we really have no control over this basic aspect of our environment. The 1982-2000 bull market in stocks enjoyed disinflationary tailwinds and steadily lower interest rates.

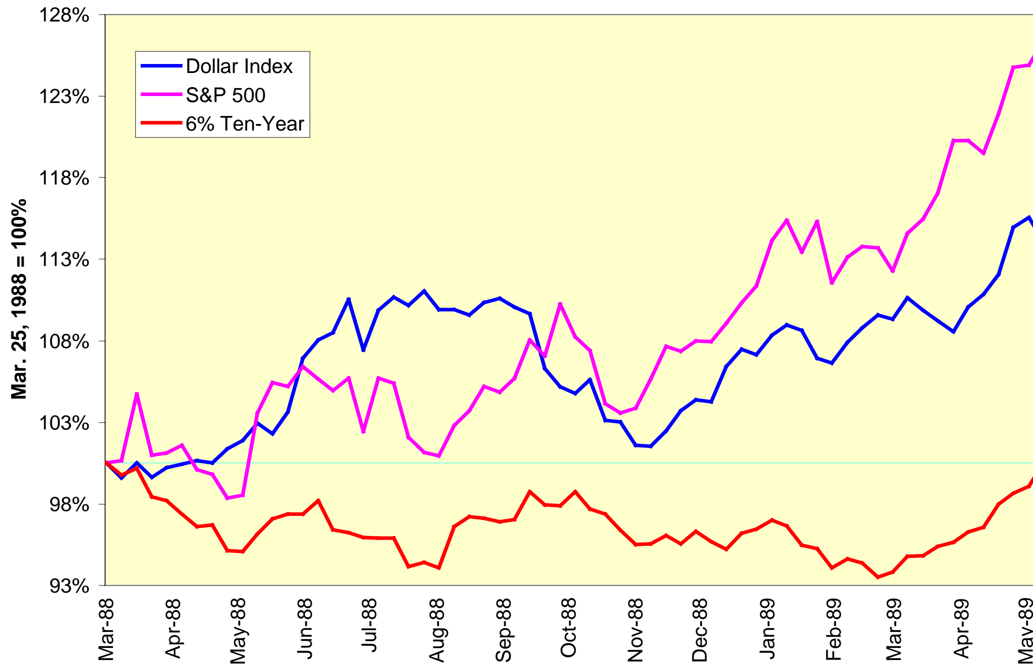
Whether this huge secular trend continues or reverses remains to be seen, but the fed funds futures market at the Chicago Board of Trade is pricing in series of rate hikes by the Federal Reserve in 2004.

It's Different This Time. And Every Time

Just as the consequences of cuts in the fed funds rate are indeterminate - how often in early 2001 did we hear the statistics about how both the economy and the stock market were supposed to respond to rate cuts - so are the consequences of higher fed funds rates. The three most recent tightening cycles occurred in 1988-1989, 1994-94, and finally in 1999-2000. While stocks, bonds and currencies all discount future Federal Reserve moves, it is instructive to see how each of these markets behaved simply during the period between the first rate hike in each cycle and the first subsequent rate cut.

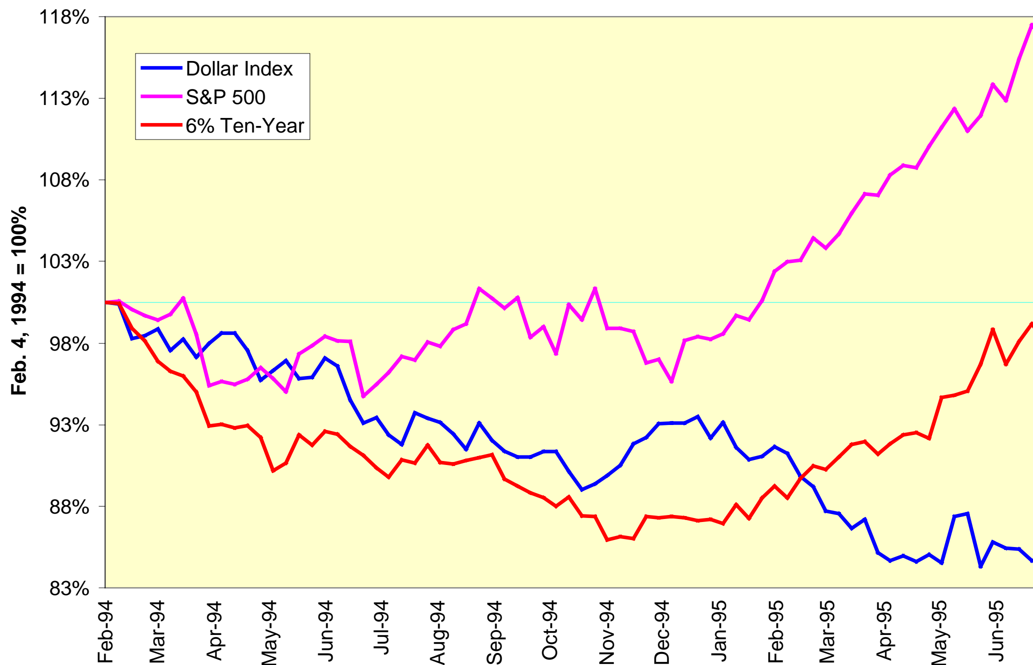
In 1988-1989, stocks sputtered for nearly six months before moving sharply higher in 1989. The dollar strengthened while both stocks were weakening over the first six-month period, and then it gave back its early rally prior to following stocks higher in 1989. Ten-year notes remained under pressure for a year and then recouped their original price level.

Reactions To 1988-89 Tightening Cycle

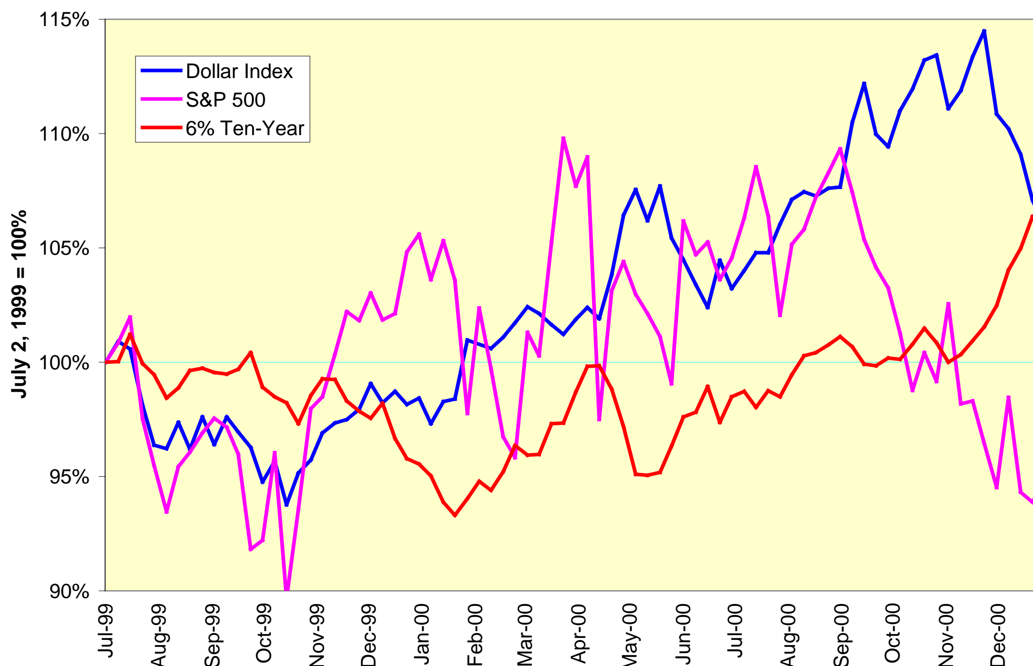


The 1994-95 experience was quite different for stocks; they stagnated for ten months before embarking on what was to be the late 1990s bull market. The dollar weakened all through the period - so much for the concept of higher interest rates and a stronger stock market supporting the dollar - while notes sank sharply before they began their rally in November 1994.

Reactions To 1994-95 Tightening Cycle



The third tightening episode saw the same selloff-and-recovery pattern in notes, a strong rally in the dollar before it began to move lower in anticipation of a U.S. recession and rate-cut cycle, and a stock chart that would scare a cardiologist.

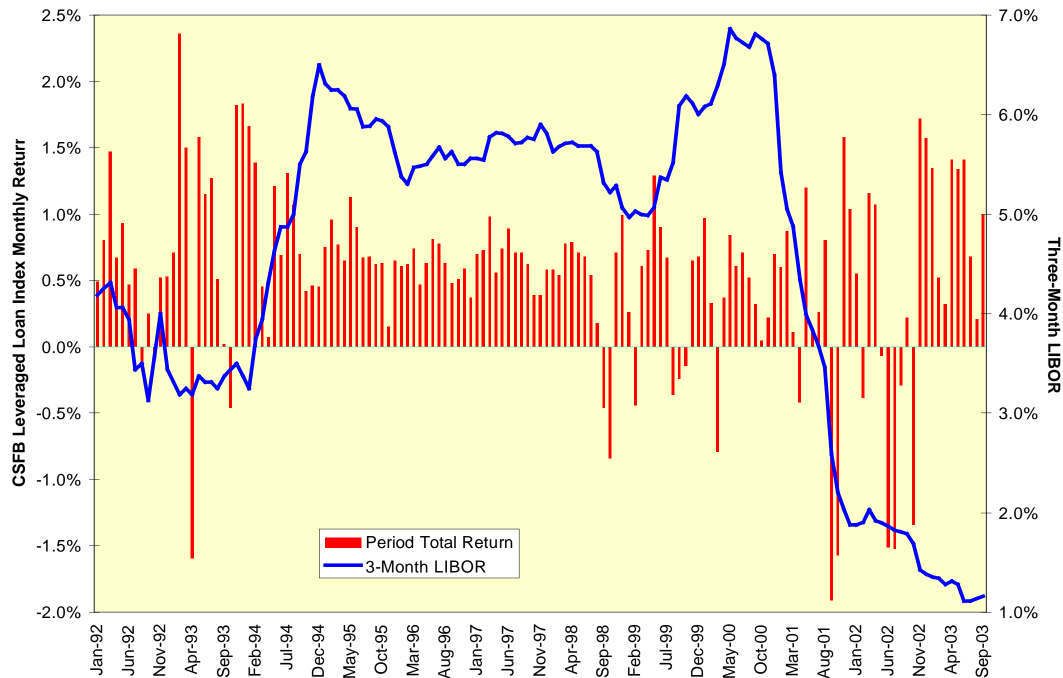


Floating Rates And Syndicated Loans

If we cannot predict the reactions of related markets to a Fed tightening, we certainly can take advantage of it while it is happening by trading the market itself. The simplest way of doing this is simply staying in cash; just as money market yields have plunged down to cost-of-operation levels with the T-bill rate still below 1%, these yields will rise with a short lag. A second trading strategy is the one highlighted at the top, and that is selling short-term interest rate future. While both the fed funds and eurodollar market already have priced rate increases into their forward curves, markets have an odd way of moving further and faster than we anticipate. It nearly defies the imagination that we will stop at 75 basis points once the Fed starts rescinding the 550 basis points of rate cuts it has made since January 2001.

A third way of participating in an increase in short-term rates is to purchase floating-rate, as opposed to fixed-rate, instruments. This is similar to a bearish interest rate swaps trader wanting to pay fixed and receive floating. As short-term interest rates rise, either the coupon on the note will be reset to a higher level or the syndicated bank loan set to some premium to LIBOR will pay out at a higher rate.

As is the case with high yield bonds, floating rate corporate debt often improves in credit quality as the economy strengthens and interest rates rise. The CSFB Leveraged Loan index, a benchmark for the floating rate loan market, has shown resilience to higher short-term rates over the past decade. Its periods of negative monthly total returns are concentrated in the fast-and-loose venture capital period of the late 1990s and in the recent recession. The negative returns during the recession were exacerbated by the sharp fall in LIBOR, which led to numerous downward resets in loan rates.



The prospects for higher short-term rates and a firmer economy should represent a strong period for syndicated bank loans; this period will continue until the inevitable lassitude of lending standards accompanying every economic boom. Several closed-end funds, such as the Eaton Vance Senior Income Trust, which is up a tidy 23.1% in 2003, are benchmarked to the CSFB Leveraged Loan index. Another closed-end fund, the Citigroup Corporate Loan Fund, is up 30.3% so far in 2003.

Diversification is to investing what location is to real estate. Conservative investors who rightfully fear the effects of growth on interest rates and who cannot turn their hearts over to the hot areas of the stock market can acquire a measure of participation in corporate growth and a measure of diversification for the interest rate risk inherent in conventional bonds.