# Understanding Central Bank Policy and its impact on Investors

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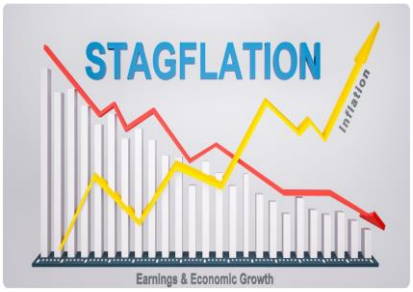
# Introduction




The reality of stagflation - Photo: Shutterstock

In recent months investors have been closely monitoring the words and actions of Jerome Powell and Christine Lagarde to see what steps the Federal Reserve and the ECB will take to tackle the threat of surging inflation which has moved from being 'transitory' to 'sticky' in popular parlance. The recent interest rate hikes (and the likelihood of future hikes) along with a move to end quantitative easing programmes have increased the level of investor uncertainty due to the impact that these Central Bank policies can have on investors' portfolios.

This paper will examine in particular the impact of Central Bank policies across a number of different asset classes namely, equities, bonds, property and infrastructure. This paper will refer to the historical period known as 'The Great Inflation' which is commonly referred to as the defining macroeconomic event of the twentieth century. The actions of the Federal Reserve at this time and the subsequent impact on asset classes will be examined. This period is noteworthy as 'Stagflation' was a huge problem and this is something that is back on the agenda for policy makers in 2022. Stagflation refers to a macroeconomic environment where there is persistent high inflation combined with high unemployment and stagnant demand in an economy. This paper will also refer to the period post the Global Financial Crisis which began in 2008 where the ECB embarked on a series of quantitative easing programmes which drove down interest rates in Europe.

## Did you know ?

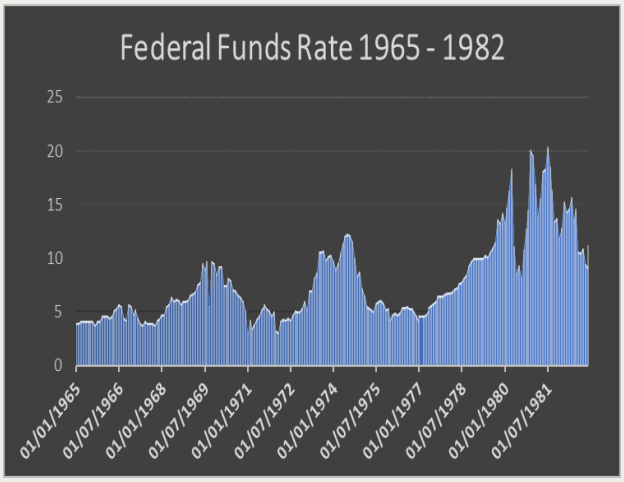
There are subtle differences in the objectives of the various Central Banks which are important to understand as they dictate the actions that they each take. The US Federal Reserve has a dual mandate - **"to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".**

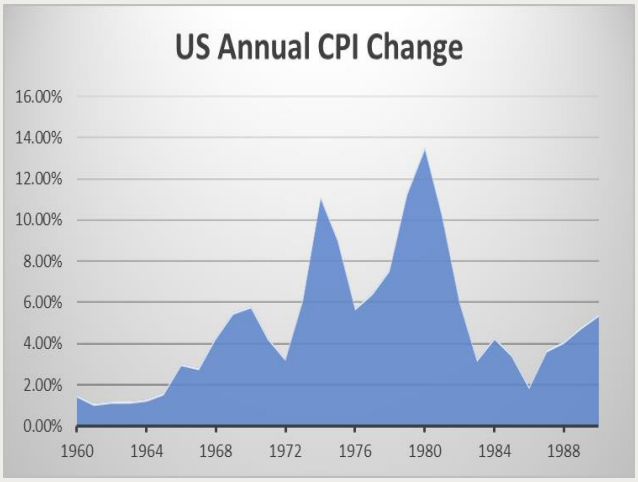
The ECB on the other hand has a **primary objective of price stability** whereby it targets 2% inflation over the medium-term as a buffer against the risk of destabilising deflation.

These differences in mandates can lead to differences in how each Central Bank tackle issues, sometimes leading to policy divergence which we are seeing to a small extent in 2022.

# The Great Inflation: 1965 - 1982

This was a tumultuous period for macroeconomic policymakers, the effects of which are still seen to this day in terms of the approach the likes of the Fed and the ECB take in their decision-making. Excessive growth in money-supply in the years post the Second World War led to hyperinflation in the US economy. At the time there was a belief among policymakers that low unemployment rates could be achieved by targeting modestly higher rates of inflation. However, the inflation situation quickly got out of hand and the Fed were forced to act decisively by raising interest rates to as high as 20%.




The graphs above demonstrate the relationship between inflation and interest rates at the time – as inflation rates increased, the Fed raised interest rates to try and counteract it. This culminated in interest rates reaching as high as 20% around 1980 to 1981 when inflation was in and around its peak of 13%.

With interest rates as high as this the impact on the economy is severe. Domestic households with even modest levels of debt struggle with interest rates at such heights and the ability of businesses to grow is greatly inhibited by the reduced access to capital when interest rates are at these levels.

Unsurprisingly, there were four recessions during 'The Great Inflation' in the US economy so stagflation was a great concern during this period. The impact of high interest rates on the various asset classes will now be examined in more detail.

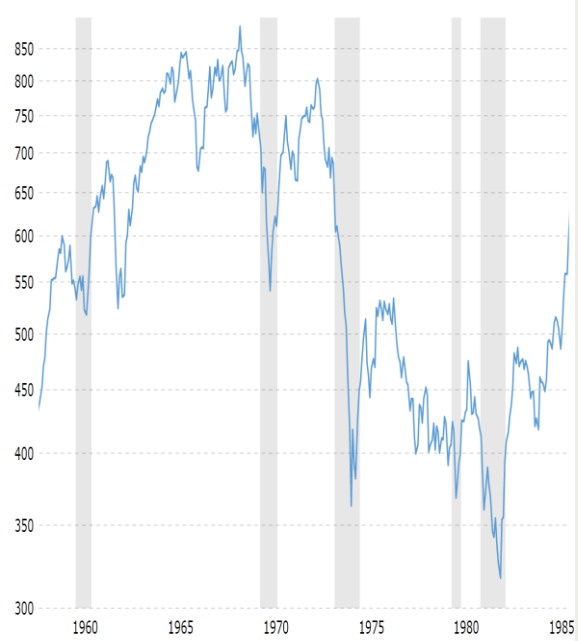
# Equities


Interest rate hikes impact the performance of the equity markets in a number of ways, both directly and indirectly. Raising interest rates means that the cost of financing increases for companies which makes it more difficult for companies to grow as they may struggle to finance long-term projects and capital infrastructure. For example, a small growing company who is manufacturing may wish to expand their business by building a bigger factory so that they can increase output and profitability. In a rising interest rate environment this becomes more difficult as the company may struggle to service the debt they take on to finance the project.

This inability to grow a business has a knock-on impact on the levels of unemployment with higher interest rates often associated with higher levels of unemployment. This reduces the money that is being spent in the economy which compounds problems for businesses that are trying to expand. On the domestic economy side, higher interest rates impact consumers with mortgages (or other variable rate debt) the most. This tends to result in people having less money to spend and less spending will impact on the ability of companies to grow which could lead to a reduction in the share price.

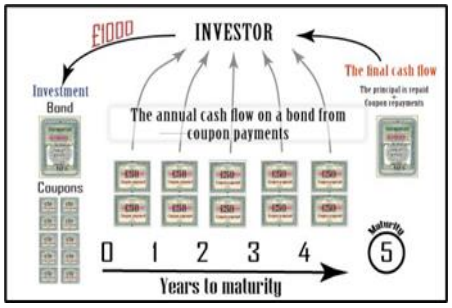
The graph on the right-hand side highlights the difficulties that equity investors had during 'The Great Inflation' period. The grey bars represent times when the US economy was in recession. Returns from equity markets as illustrated by the level of the S&P 500 were poor.

It is important to note that despite the unfavourable conditions, even within equity markets there are opportunities for investors. Value stocks tend to be less sensitive to interest rate hikes as their cashflow profiles are more front-ended and of shorter duration than that of growth stocks. Value stocks tend to have stronger balance sheets and are often less highly geared which makes them less exposed in a rising interest rate environment. Already in 2022 we have seen evidence of this with a sharp rotation from growth to value stocks within the overall equity market due to the likely superior returns within value stocks with the backdrop of higher rates



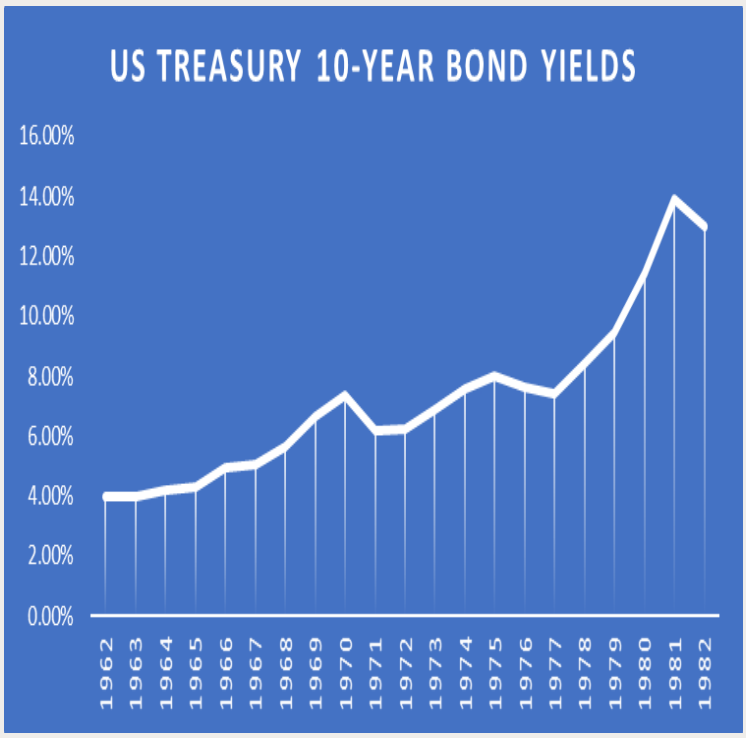

**S&P 500 Index during The Great Inflation. Source: macrotrends.net**

# Bonds



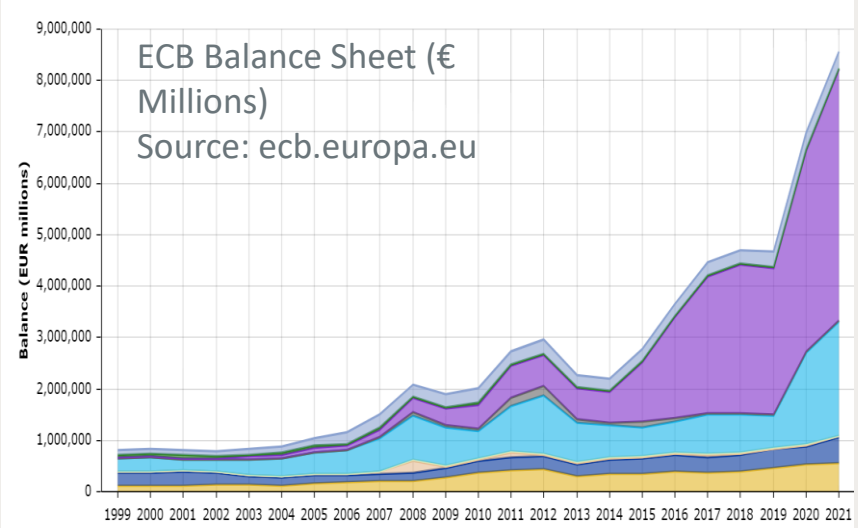

There is a strong correlation between the base interest rates set by Central Banks and the yields available on government bonds. Given the inverse relation between bond yields and bond prices, this means that when yields are rising the price is falling and so generating capital returns by investing in bonds is difficult. On the other hand higher yields can suit investors who are trying to match liability payments e.g. - in a defined benefit pension scheme.

When inflation is high, investors also tend to demand additional yield to compensate – this is referred to as the inflation risk premium. Therefore in a time such as 'The Great Inflation' where inflation was high and the Fed were raising interest rates, there was huge upward pressures on US Treasury yields which is evident in the graph on the right..



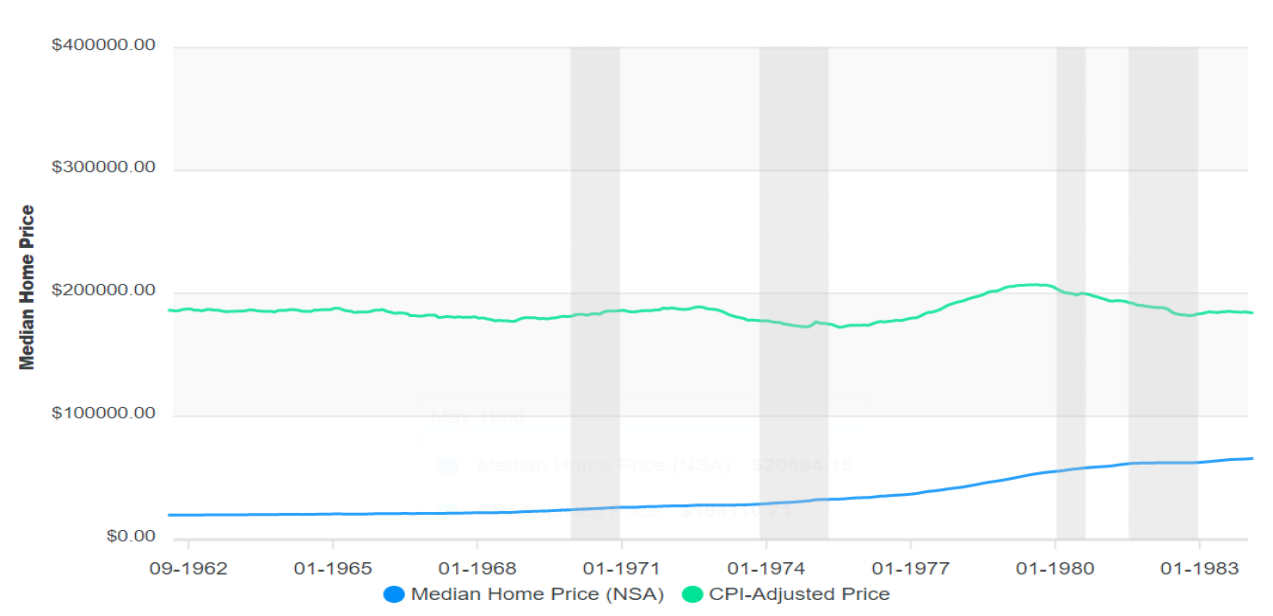

**Source: macrotrends.net**

On the other hand, the quantitative easing programmes that the ECB implemented in the years following the Great Financial Crash resulted in a higher demand for Eurozone bonds – both sovereign and corporate. This along with low base interest rates set by the ECB led to an era of low yields and high bond prices. The 2nd graph on the right shows how the ECB balance sheet more than quadrupled over the last 10 years. This demand led to asset price inflation across Europe.



# Property

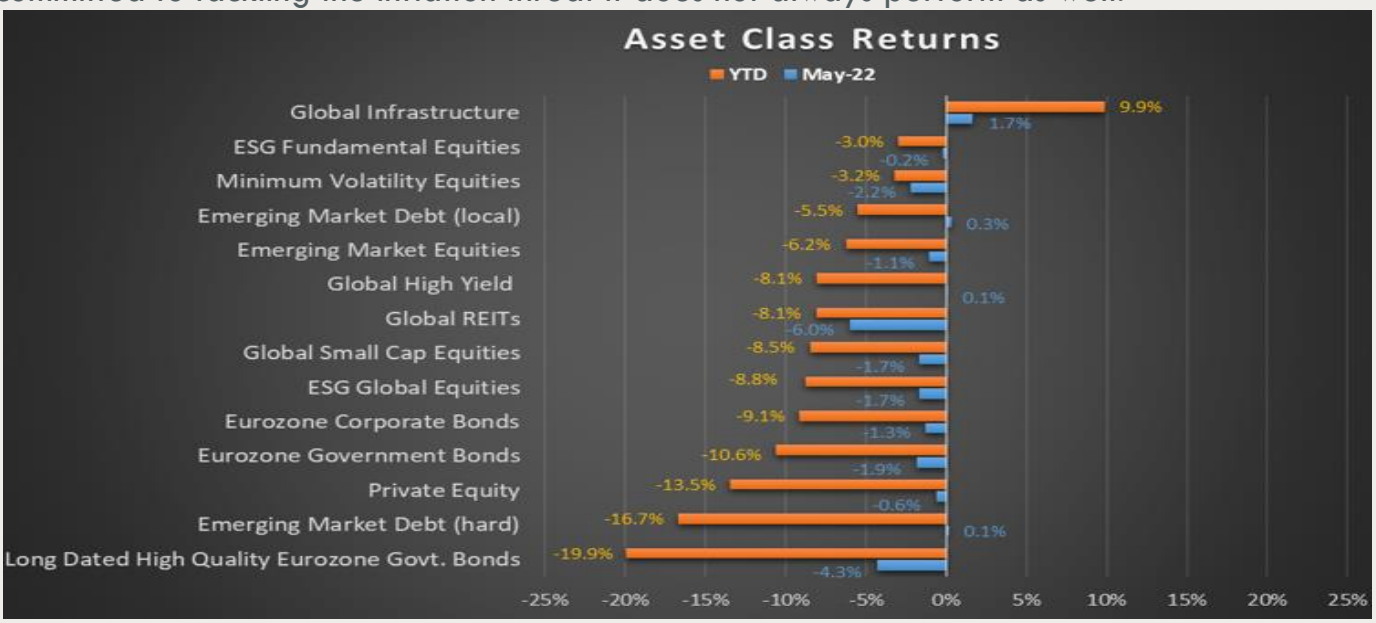
All else being equal, one would expect that when interest rates are high or rising, that property valuations shift downwards due to less demand. In the domestic property sector, higher interest rates lead to higher mortgage rates which makes housing more unaffordable for the domestic consumer. However, this is not necessarily always the case as there are multiple other factors at play in the housing market. Housing as a good exhibits relatively inelastic demand. Given that housing is a necessity, demand does not drop as much when the price rises as it would do with other goods. This trend was exhibited in the US during The Great Inflation and as the below graph demonstrates, on a CPI adjusted basis, the median home price in the US did not change much at all over the period despite vastly higher interest rates.




On the commercial property side, demand is more closely linked to the health of the economy. When the economy is stronger one would expect that companies are more likely to expand their operations and demand for commercial property should increase. This would result in the value of commercial property portfolios increasing. Rising interest rates also increases the cost of financing for companies which makes it more difficult for them to grow. Therefore, rising interest rates may negatively impact the performance of commercial property portfolios. However, it is important to note that when it comes to property there are many other factors at play such as quality of the property, location of the property, ability to change use in the future (e.g. from commercial to residential) and these factors will have more of a bearing on the valuations than interest rates alone.

# Infrastructure

Infrastructure assets tend to be characterised by their long-lives and high barriers of entry associated with investing directly. These investments tend to be capital intensive at the early stages of the project and thus can often be highly leveraged. As such due to the long duration and high levels of gearing one might expect that these assets are quite sensitive to a rising interest rate global-macro environment. However, there is a distinction to be made between an environment where interest rates are being raised to counteract inflation and when interest rates are being raised for other reasons. Infrastructure assets tend to perform well in an inflationary environment and this trend was seen at the start of 2022 with infrastructure being one of the few asset classes to deliver positive returns in Q1 and the early part of Q2 as evidenced in the below graph. Of course, since the end of April infrastructure has not performed as well which suggests that although it is a reasonably good inflation hedge, in an environment such as the current one where Central Banks have committed to tackling the inflation threat it does not always perform as well.




The reason for infrastructure performing well in inflationary environments in general is that infrastructure assets often display monopolistic tendencies due to the high up-front costs associated with the projects. This makes them price makers as opposed to price takers and so the projects backing infrastructure funds are often able to pass on the costs of rising inflation to the consumer. As discussed in the *Invesco Education Series of Q3 2021*, infrastructure assets can represent a good inflation-hedge and as such an allocation to infrastructure can help in designing a well-diversified portfolio.

# Summary and Conclusion



While the policies of Central Banks undoubtedly have an impact on investor portfolios, ultimately this is something that is out of investor's control. The best protection that an investor can bring to their portfolios is to stick to the long-established principles of investing. When designing an investment strategy, investors need to establish their investment objectives, purchase assets in line with these objectives and continue to monitor the portfolio to assess if the portfolio is on track to meeting those objectives.

In this paper we have shown that asset classes react differently to changes in Central Bank policy. Even within asset classes there can be differences in how assets tend to perform. A well-diversified portfolio that is designed with the investment time horizon of the investor in mind remains the best strategy. As we saw in a previous paper in the *Invesco Education Series (Q1 2022)*, time in the market is more important than timing the market and this remains true for the long-term investor.

For more information on the contents of this paper please feel free to reach out to us.

IF YOU HAVE ANY QUESTIONS ABOUT THE INFORMATION IN THIS DOCUMENT, PLEASE CONTACT YOUR INVESTMENT CONSULTANT.

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