

Seven reasons to favor US stocks in Fed tightening cycles

Equity Strategy Special Edition

February 2022

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The Federal Reserve's (Fed's) hawkish pivot is on many investors' minds, and with good reason. We answer these seven questions from clients about stock market performance during Fed tightening cycles.

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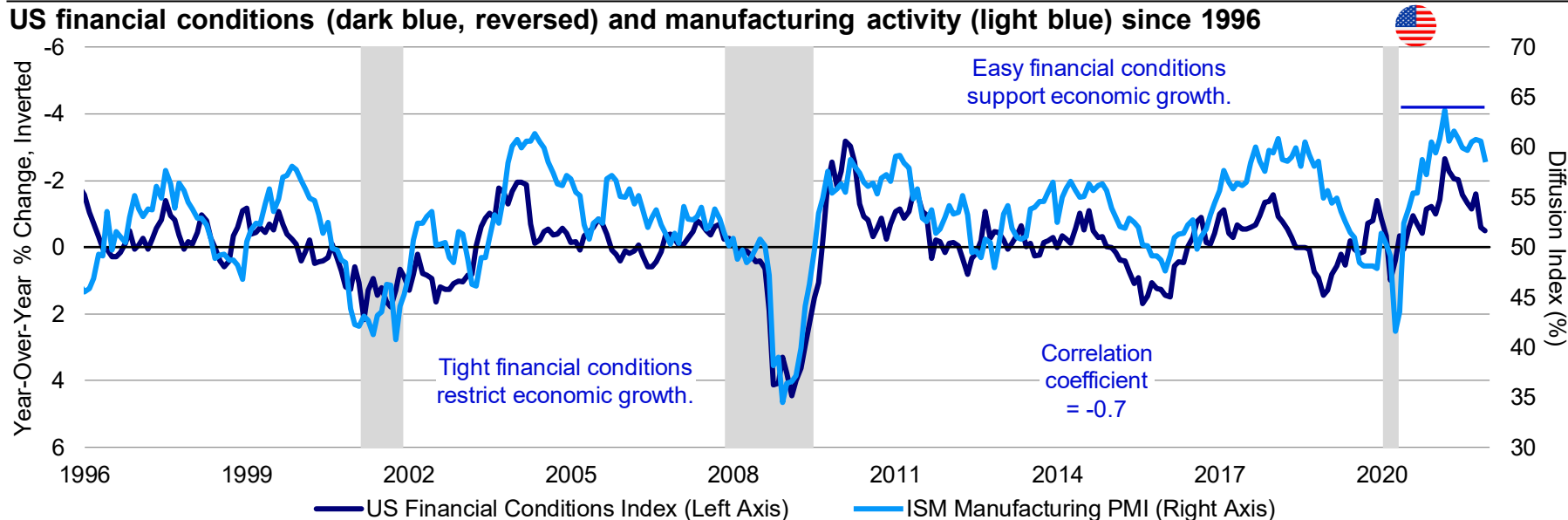
1. How's the Fed responding to inflation and a tight labor market?

US policymakers are starting to remove monetary support to cool down an overheating economy. Financial conditions remain easy but are becoming less so.

There has been a strong inverse relationship between financial conditions, which are influenced by a country's central bank, and manufacturing activity over time. Specifically, easy financial conditions are tailwinds for economic growth, and tight financial conditions are headwinds for economic growth.

In the US, financial conditions remain easy, but a hawkish Fed, flatter yield curve, and strong US dollar have coincided with slower manufacturing activity. That said, we think it's unlikely the Fed will kill the "golden goose" by crushing growth and causing a double-dip recession. After all, US policymakers haven't even fired a single shot yet in the form of interest-rate hikes. Moreover, we think it's the last hike that matters, not the first.

US financial conditions (dark blue, reversed) and manufacturing activity (light blue) since 1996



Sources: Bloomberg L.P., Goldman Sachs, Macrobond, Invesco, 12/31/21. **Notes:** The US Financial Conditions Index includes the federal funds rate, 10-year Treasury bond yield, BBB corporate bond spread, S&P 500 and US dollar. ISM = Institute for Supply Management. PMI = Purchasing Managers Index. NBER = National Bureau of Economic Research. Shaded areas denote NBER-defined US recessions. An investment cannot be made in an index. See page 11 for index definitions. **Past performance does not guarantee future results.**

2. How did US stocks perform in past Fed tightening cycles?

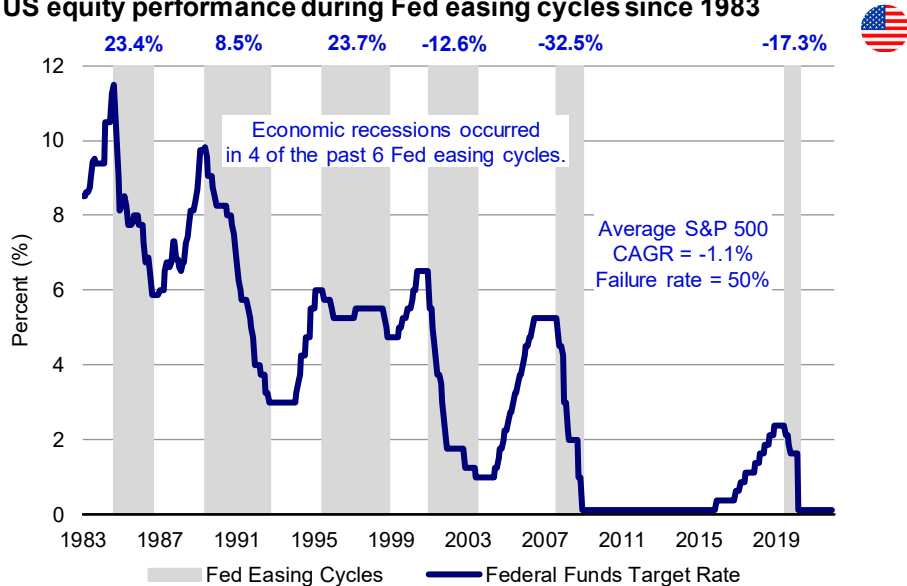
Fortunately, the US stock market generally did better during Fed tightening cycles, which occurred in the second half of business cycles 67% of the time.

Contrary to popular belief, US stocks generally did better during Fed tightening cycles than during Fed easing cycles.

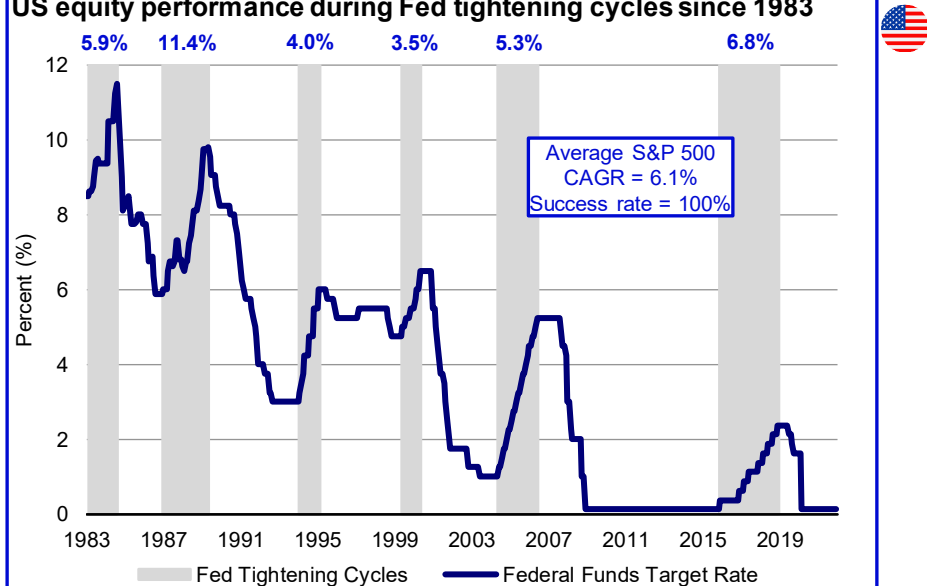
That's because Fed tightening occurred in the second half of US business cycles 67% of the time, and Fed easing overlapped with US economic recessions 67% of the time.

It would be unusual for the stock market advance to end this early in a Fed tightening cycle. In our view, the last hike matters more than the first. Until then, we remain buyers of stocks on the dips.

US equity performance during Fed easing cycles since 1983



US equity performance during Fed tightening cycles since 1983



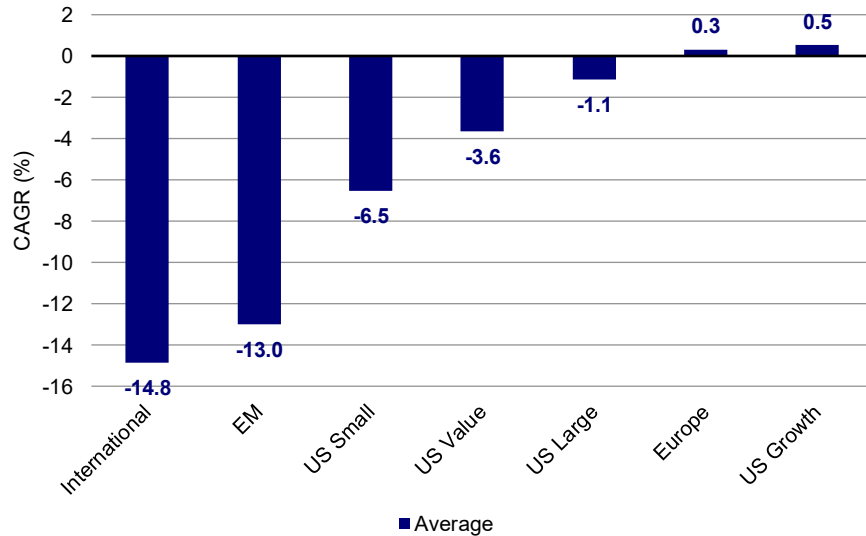
Sources: Bloomberg L.P., Invesco, 12/31/21. **Notes:** In the right chart, shaded areas denote Fed tightening cycles from first to last hike (1983-1984, 1987-1989, 1994-1995, 1999-2000, 2004-2006, and 2015-2018). In the left chart, shaded areas denote Fed easing cycles from first to last cut (1984-1986, 1989-1992, 1995-1998, 2001-2003, 2007-2008, and 2019-2020). CAGR = Compound annual growth rate. US stocks = S&P 500. Price returns in US dollars. An investment cannot be made into an index. **Past performance does not guarantee future results.**

3. What about global equities?

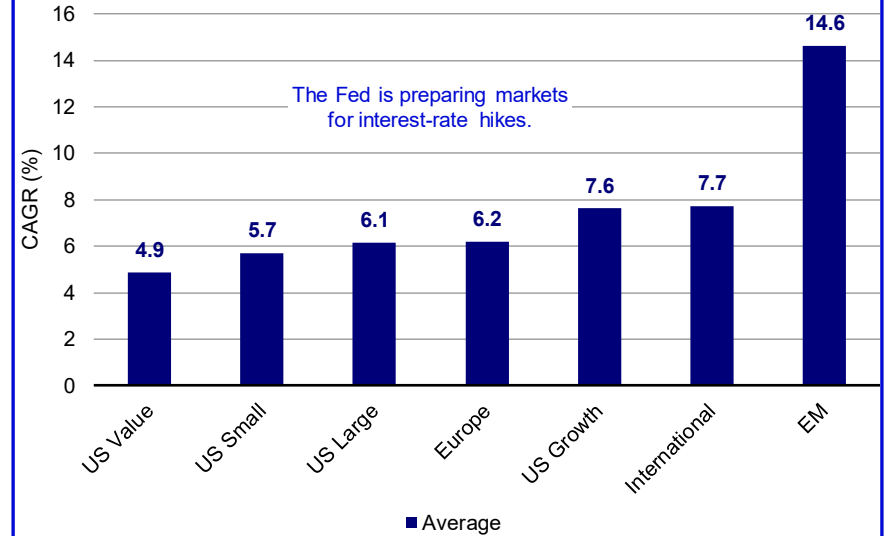
Similarly, global equities generally did better when the Fed was raising interest rates.

Typically, style, size, US, and non-US equities all performed better when the Fed was raising interest rates.

Global equity performance during Fed easing cycles since 1983



Global equity performance during Fed tightening cycles since 1983



Sources: Bloomberg L.P., Invesco, 12/31/21. **Notes:** EM = MSCI Emerging Markets Index. International = MSCI ACWI ex USA. US growth = Russell 1000 Growth. Europe = MSCI Europe Index. US large = S&P 500. US small = Russell 2000. US value = Russell 1000 Value. Price returns in US dollars. An investment cannot be made into an index. **Past performance does not guarantee future results.**

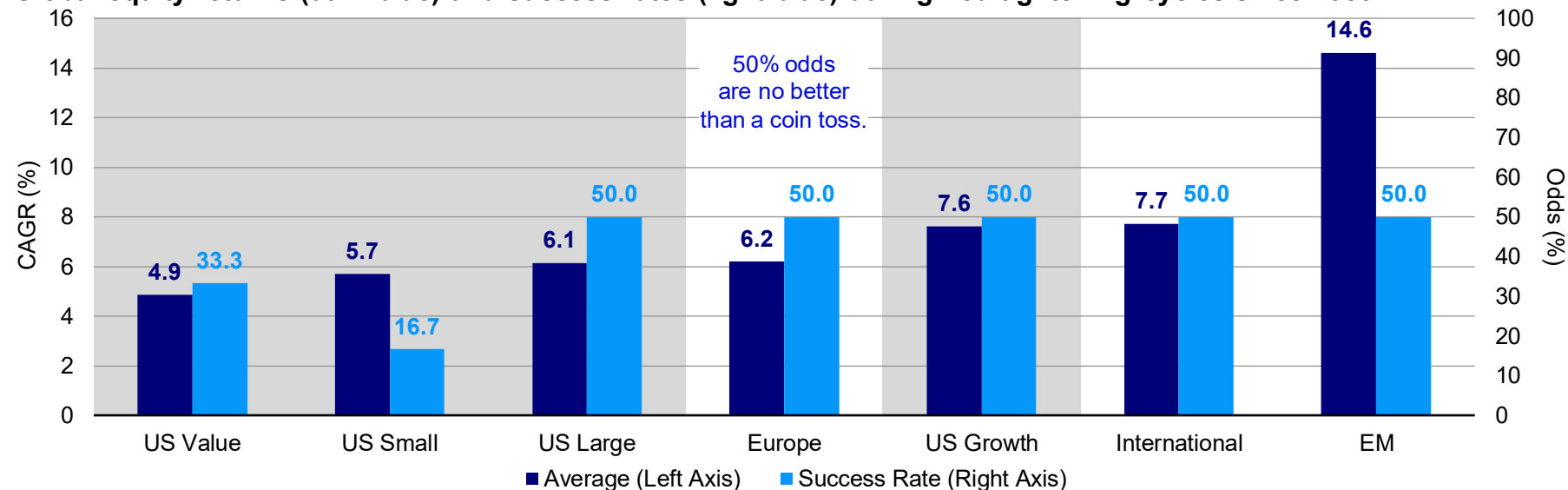
4. Was leadership consistent across categories?

On average, non-US stocks outperformed US stocks in Fed tightening cycles. However, no single category ranked in the top three more than 50% of the time!

Unfortunately, investors who are looking for consistent global equity leadership (ourselves included) during Fed tightening cycles may be disappointed.

Whether it was style, size, US, or non-US equities, not a single category ranked in the top three more than 50% of the time in our sample.

Global equity returns (dark blue) and success rates (light blue) during Fed tightening cycles since 1983



Sources: Bloomberg L.P., Invesco, 12/31/21. **Notes:** Success rate = Number of times each category ranked in the top three across six tightening cycles. Shaded areas denote US stocks. White areas denote non-US stocks. An investment cannot be made into an index. **Past performance does not guarantee future results.**

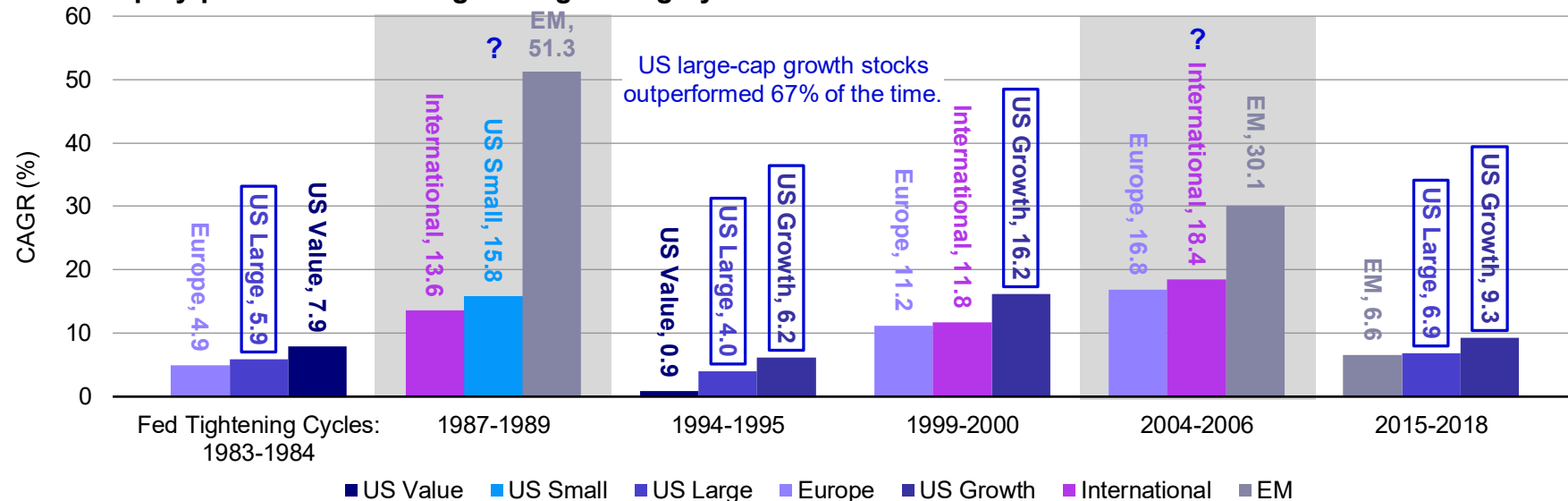
5. How should investors position themselves in this Fed tightening cycle?

Change was constant across tightening cycles. But we expect US large-cap growth to resurface, given tighter fiscal and monetary policy coupled with slower activity.

For example, US large-cap growth stocks topped the leader board in the 2015-2018, 1999-2000, 1994-1995, and 1983-1984 Fed tightening cycles. However, the same category didn't appear in the 2004-2006 or 1987-1989 Fed tightening cycles.

In our view, the combination of slower economic and earnings growth, exacerbated by tighter fiscal and monetary policy, point to higher quality positioning in large-cap growth stocks, the recent selloff in which we believe presents another attractive entry point.

Global equity performance during Fed tightening cycles since 1983



Sources: Bloomberg L.P., Invesco, 12/31/21. **Notes:** Shaded areas denote episodes when US large-cap growth underperformed. White areas denote episodes when US large-cap growth outperformed. An investment cannot be made into an index. **Past performance does not guarantee future results.** These comments should not be construed as recommendations but as an illustration of broader themes.

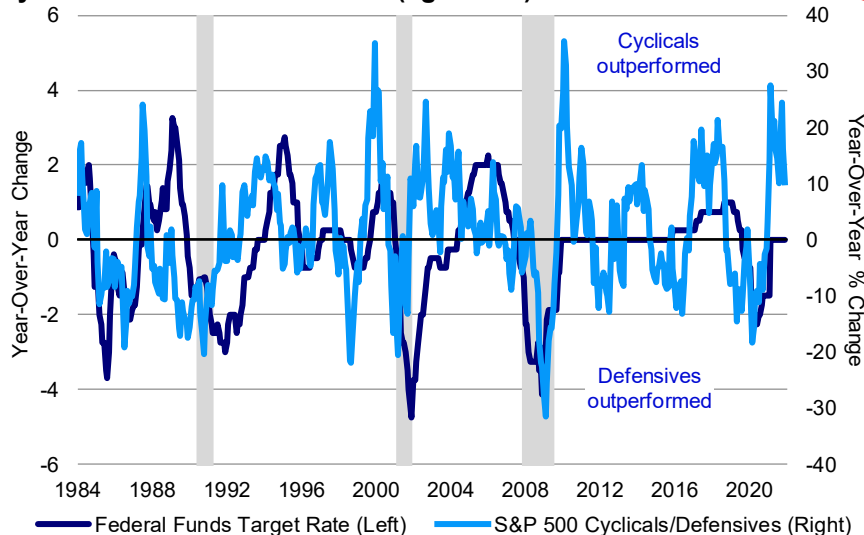
6. What about sectors?

US cyclical sectors outperformed their defensive counterparts in four of the last six Fed tightening cycles.

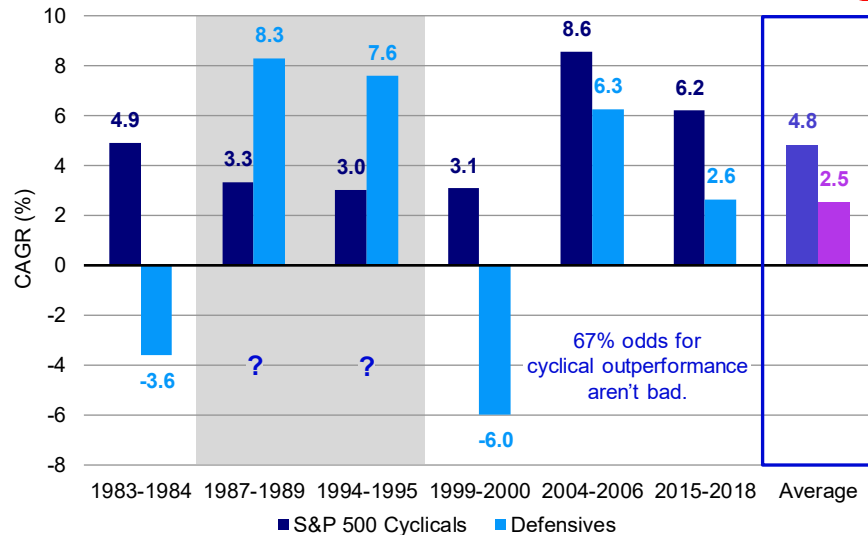
It would be unusual for the cyclical advance to end this early in a Fed tightening cycle. As we're fond of saying, the last hike matters most. Until that time, we remain buyers of cyclicals on the dips.

We believe that persistent defensive sector outperformance likely awaits an economic downturn. However, we see plenty of runway ahead for this business cycle. As such, we think it's too soon to get outright defensive by fully embracing counter-cyclicals. In our view, the economy-sensitive, cyclical sectors of the market remain the place to be for now.

Federal funds target rate (dark blue) and the performance of US cyclicals relative to defensives (light blue) since 1984



US sector performance during Fed tightening cycles since 1983

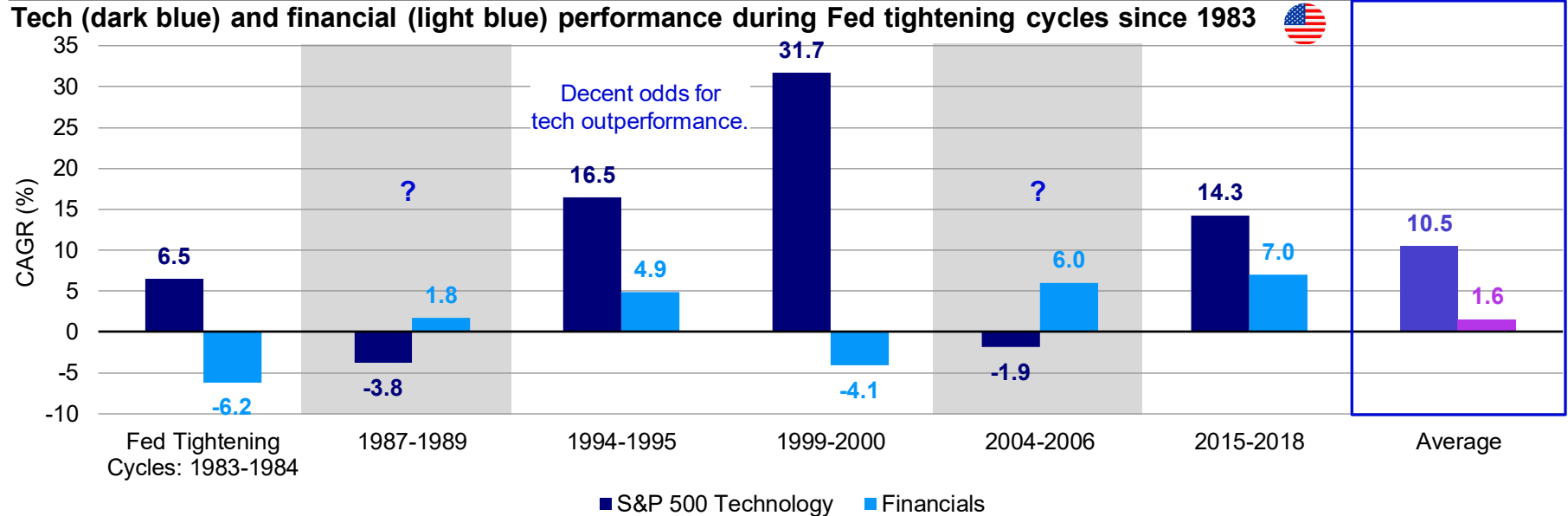


Sources: Bloomberg L.P., Invesco, 12/31/21. **Notes:** Cyclicals = S&P 500 consumer discretionary, energy, financials, industrials, information technology, and materials indices. Defensives = S&P 500 consumer staples, health care, telecommunication services, and utilities indices. In the left chart, shaded areas denote NBER-defined US economic recessions. In the right chart, shaded areas denote episodes when cyclicals underperformed defensives. White areas denote episodes when cyclicals outperformed defensives. An investment cannot be made into an index. **Past performance does not guarantee future results.**

7. Within cyclicals, what should investors favor?

In Fed tightening cycles, tech (growth) outperformed financials (value) most of the time.

Consistent with our expectation for continued US large-cap growth outperformance, we believe that tech stocks will become interesting to investors once again after their recent correction. More often than not, tech outperformed financials during Fed tightening cycles.



Sources: Bloomberg L.P., Invesco, 12/31/21. **Notes:** Shaded areas denote episodes when technology underperformed financials. White areas denote episodes when technology outperformed financials. An investment cannot be made into an index. **Past performance does not guarantee future results.** These comments should not be construed as recommendations but as an illustration of broader themes.

Global Thought Leadership

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Talley Léger is the Senior Investment Strategist for the Global Thought Leadership team. In this role, he is responsible for formulating and communicating macro and investment insights, with a focus on equities. Mr. Léger is involved in macro research, cross-market strategy, and equity strategy.

Mr. Léger joined Invesco when the firm combined with OppenheimerFunds in 2019. At

OppenheimerFunds, he was the equity strategist. Prior to OppenheimerFunds, he was the founder of Macro Vision Research and held strategist roles at Barclays Capital, ISI, Merrill Lynch, RBC Capital Markets, and Brown Brothers Harriman. Mr. Léger has been in the industry since 2000.

He is the co-author of the revised second edition of the book *From Bear to Bull with ETFs*.* Mr. Léger

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Mr. Léger earned a Master of Science in Financial Economics and a Bachelor of Music from Boston University. He is a member of the Global Interdependence Center (GIC) and holds the General Securities Representative registration.

**From Bear to Bull with ETFs* (2nd ed.), by David R. Kotok and Talley Léger, published by Cumberland Advisors Publishing (2014).

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February 2022



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