

FCM Weekly Market Notes

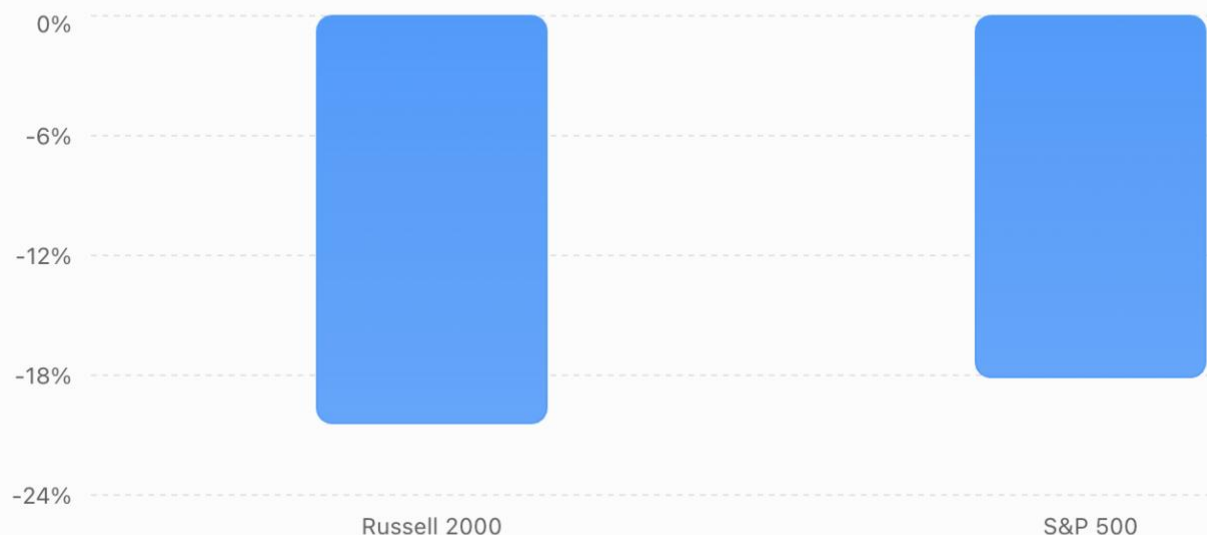
What Not to Buy in a Rate Hiking Cycle

While every rate hiking cycle is different, it's similar in what your broad investing playbook should be.

Number one on the list of market areas to avoid are **small cap stocks**. This hiking cycle started to be priced in right after a period of outsized gains for small caps—year-to-date up to August, small caps had nearly doubled the S&P at 18.11% versus 9.41%, providing another reason to consider lightening up. Since then, the S&P is up over 3% while small caps are down over 3%.

2022: Small Caps Fell More Than Large Caps

Total return during the Federal Reserve's rapid 2022 tightening cycle.



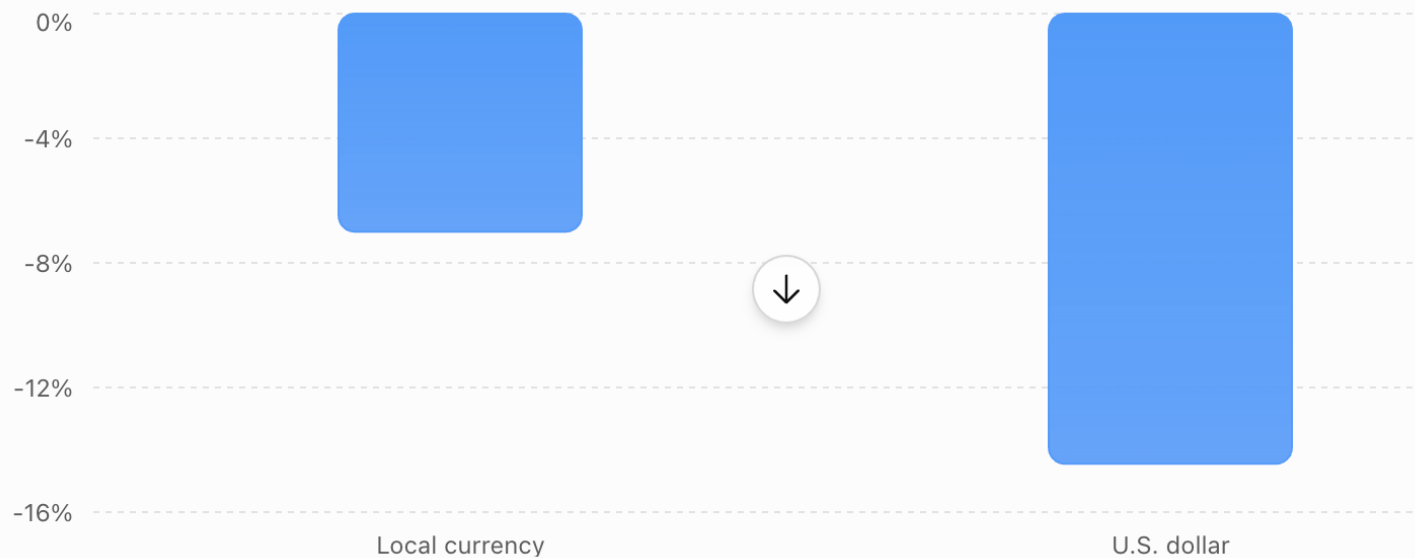


When rates are rising and financial conditions are tightening, small caps can face a double headwind—higher financing costs and tighter access to capital. When the cycle eventually shifts toward lower rates and easier financial conditions, those same forces can become a tailwind. That point is clearly some time away.

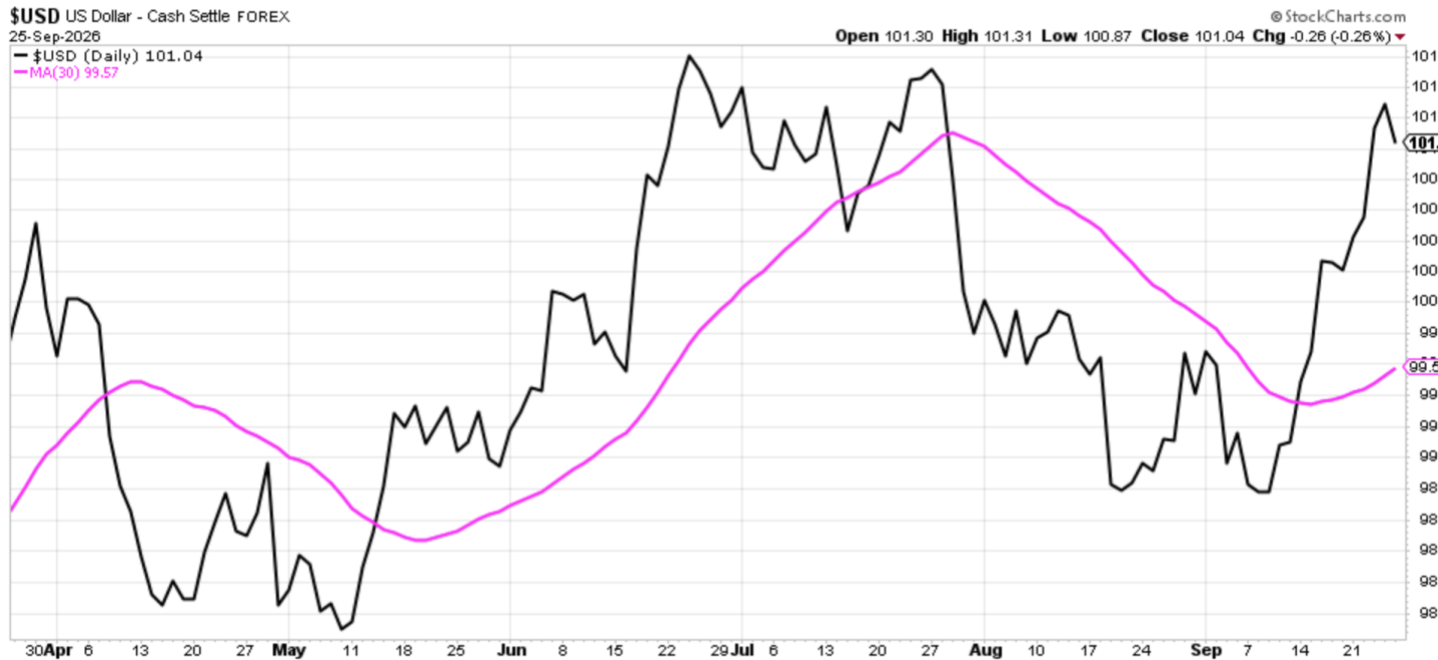
Area number two is **international stocks**. In static portfolio allocations for retail investors, international stocks are almost always included as a portfolio diversifier. But that should change as cycles change.

2022: A Strong Dollar Cut International Equity Returns

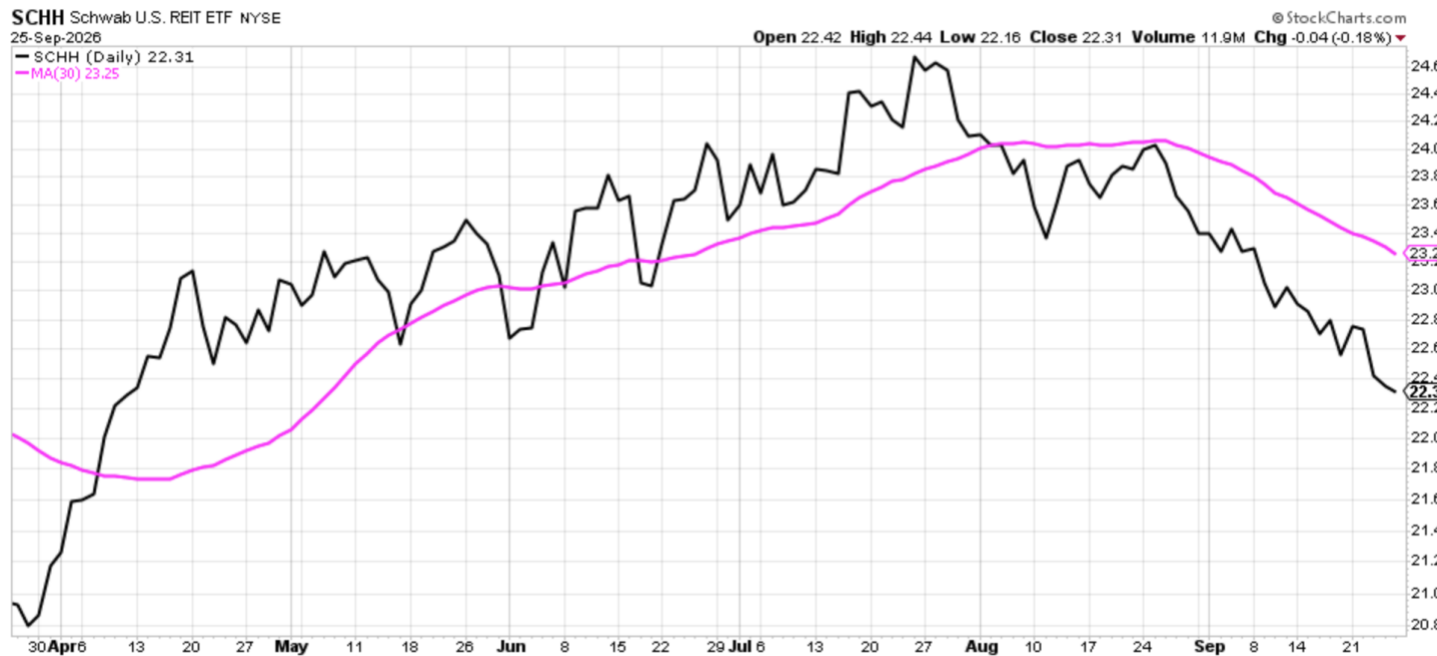
MSCI EAFE total return in local currencies versus U.S. dollars during the 2022 Federal Reserve tightening cycle.



A strengthening US dollar curbed international returns, and they underperformed S&P, although by only a percent. In this cycle, that disparity may widen as the dollar has already started to soar.



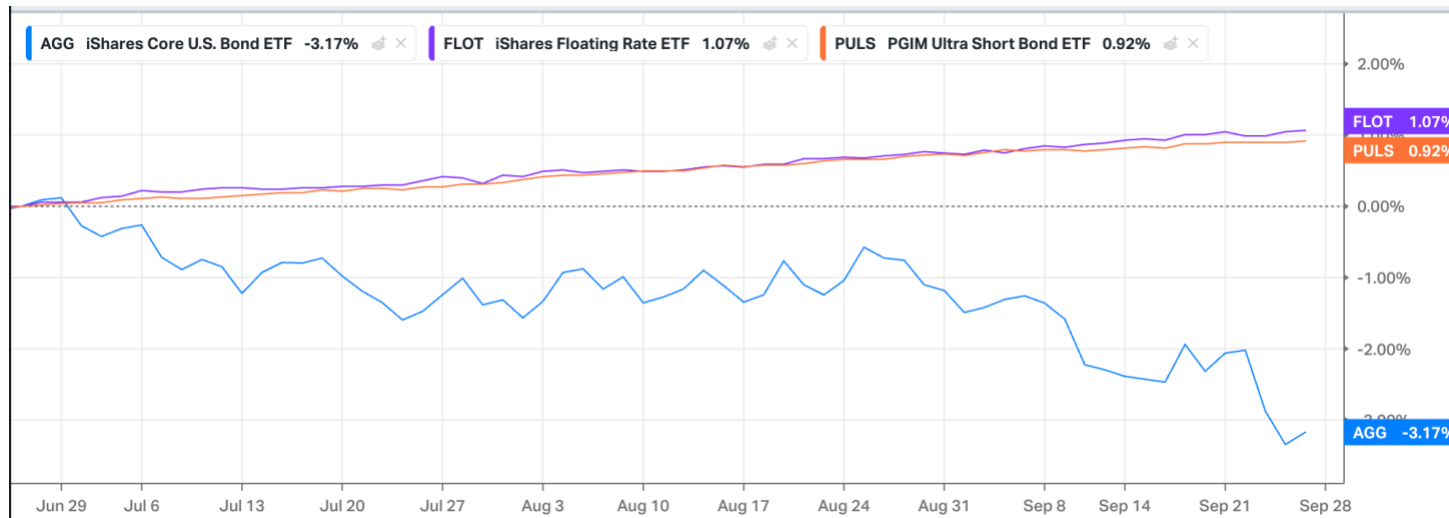
The negative effect of a hiking cycle also extends to income segments that are not pure fixed income. Until we see where yields find an equilibrium, these areas are best to be avoided as well, although the ability to have exposure to real assets should eventually benefit investors who wait for price action to confirm more attractive entry. This chart shows the largest REIT ETF:



A similar analysis holds for the MLP space, traditionally used for income—an eventually attractive option, once yields settle.



And that brings us to bonds. A casual reader of the financial press is quite aware that yields have risen sharply, especially in long duration bonds. There is no need to pick a yield that might seem attractive to you at this point in the cycle, as pundits who have bond funds to sell might urge you to. Instead, very short duration and floating rate strategies can keep you safely participating in the rise in yields—why gamble and pretend that you can forecast the future in yields?



According to current market pricing, this hiking cycle has much more room to run—which increases the need for investors to weed out weak links in their portfolio and not statically sit on the sidelines. By next year's April Fed meeting, the market has over a 50% chance rates will be 75 basis points—or more!—higher than today.

We will discuss how risk assets might perform in that scenario next week. Given the recent stock performance that is harder to predict. But the current hiking cycle playbook is not.



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