5% Fed Fund Rates are Not the End of the World… In Fact, They are Normal

Since the Federal Reserve began its rate hiking cycle in March 2022, there has been a near-constant drumbeat that higher interest rates would drive the economy into recession. The common view wasn't *whether* we would end up in a recession, but rather, how deep and long-lasting it would be. After all, how could the economy grow after the Federal Reserve brought the Fed funds rate to a targeted 5.25-5.50% versus near zero rates only 18 months ago?

This question ignores over sixty years of history during which Fed funds rates were at or above 5%. We are not naive enough to think that higher rates haven't and won't continue to slow portions of the economy that are more interest rate sensitive than others, particularly given the speed at which the Fed funds rate was increased. We do not, however, believe rates at these levels will lead to the end of the US economy, a catastrophic collapse in any major economic indicators, or the destruction of the small and microcapitalization companies in which we invest.

Are Fed funds rates, even at 5%, at historically low levels despite being significantly higher than they have been for over 15+ years? Yes, they are. Has the economy and earnings of perceived "risk" assets ever grown with a Fed Funds rate at 5%? More often than you may think. Have small capitalization stocks performed well with Fed funds rates at 5%? Absolutely. Recent history convinced investors that near-zero interest rates are required for economic prosperity, particularly for "risk" assets. However, long-term history dispels this belief. We believe this time is ***not*** different. If we are correct, and long-term history repeats itself, the ensuing years could be not only a continued period of strong economic growth, but also a period of strong returns for stocks of small and microcapitalization companies.

Recent History: ZIRP

The housing market deterioration that began in 2007, spurred what would eventually result in an aggregate 525 basis point reduction to the targeted fed funds rate across ten separate cuts over 15 months. This zero-interest rate policy (or "ZIRP"), which also included various quantitative easing programs, was certainly effective in mitigating the economic fallout from the financial crisis of 2008/2009. GDP growth resumed in earnest in 2010, but the Federal Reserve did not raise rates whatsoever until December 2015, *seven years* after setting the target Fed funds range to 0-25 basis points. Even then, rate increases were gradual through 2018 before some cuts were made in 2019 due to economic uncertainties resulting from trade disputes between the U.S. and China along with slowing economic growth.

In March 2020, as economic activity was grinding to a halt due to the onset of the COVID-19 pandemic, the Federal Reserve lowered the Fed funds rate to 0-0.25% and announced further quantitative easing programs in a series of emergency meetings. While an effective means to deal with the calamity at hand at the time, these polices, along with historically large amounts of government stimulus funding, remained in place after the economic effects of the pandemic abated.

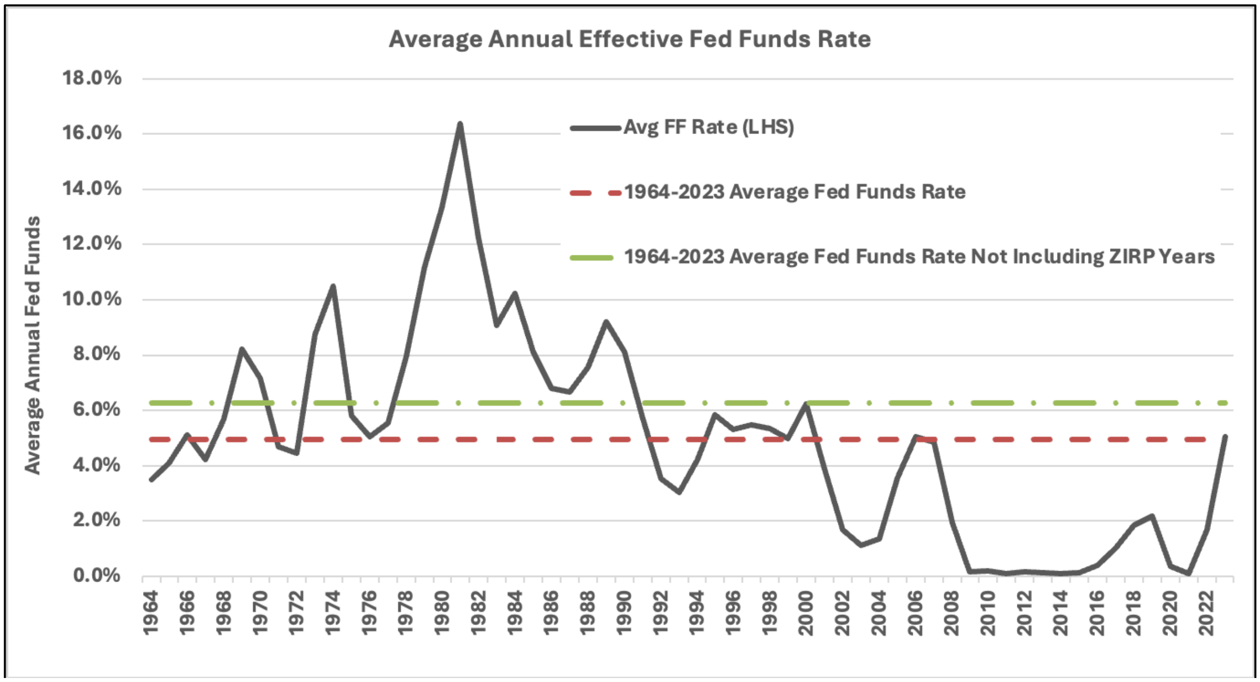
When capital is essentially free like the Fed allowed for so long, liquidity naturally seeps into odd and novel pockets of the market, or even creates new ones. Here is one extreme example: it's truly remarkable to think someone was willing to spend $3.4 million on a non-fungible token (or NFT) of a cartoon ape less than three years ago.

Source: X

During this period, there were certainly extensions of irrational exuberance across sectors of the public markets, particularly so-called "meme" stocks and early-stage companies that completed public listings through special purpose acquisition companies, or SPACs. While each of these "bubbles" created and ultimately ended up destroying wealth, arguably the worst outcome was the perception that ZIRP was required to build value in all "risk" assets, including established, but relatively small businesses including small and microcapitalization public companies.

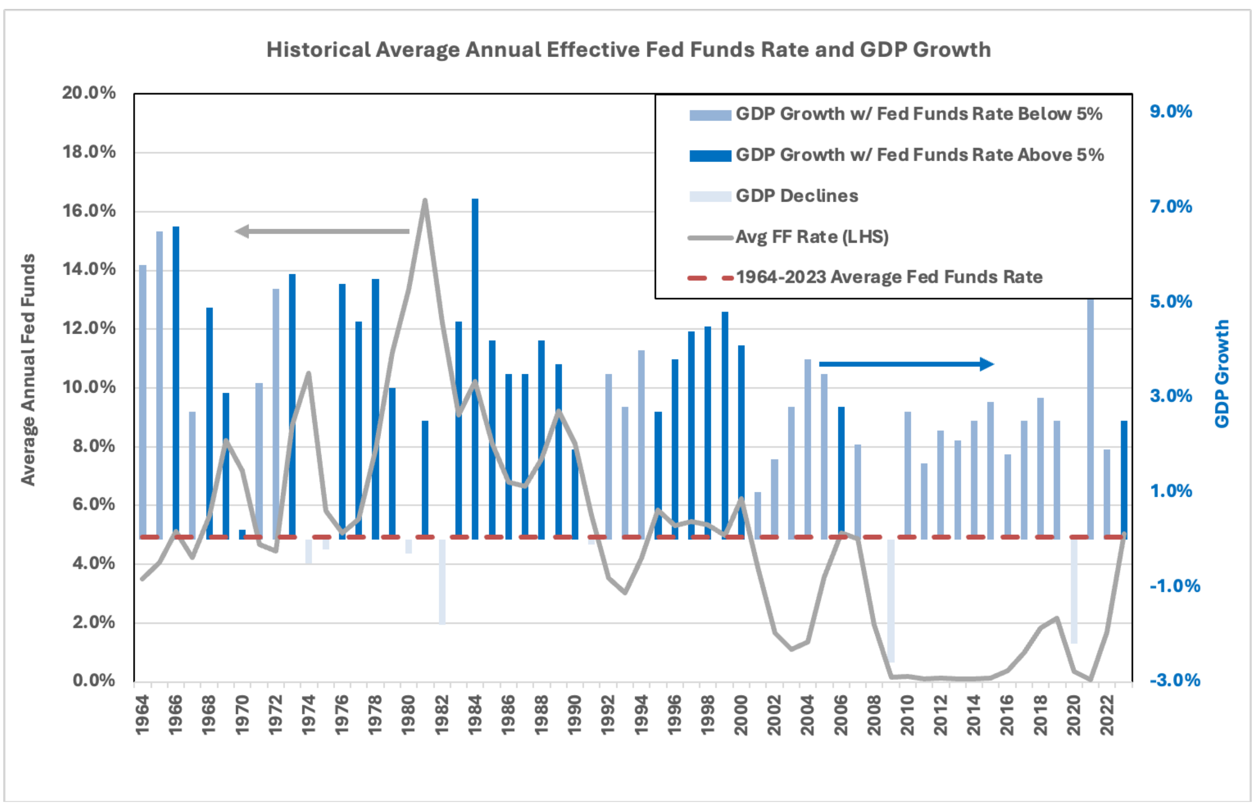
<u>Long-Term (i.e., We Believe More Relevant) History:</u>

Given that many investors have known nothing other than periods of ZIRP, it is hard for them to fathom that there is economic life outside of that policy for any company other than the ones that are the largest and most well-capitalized. This theory could not be further from the truth based on historical data. Let's first look at the history of Fed funds rates since 1964.



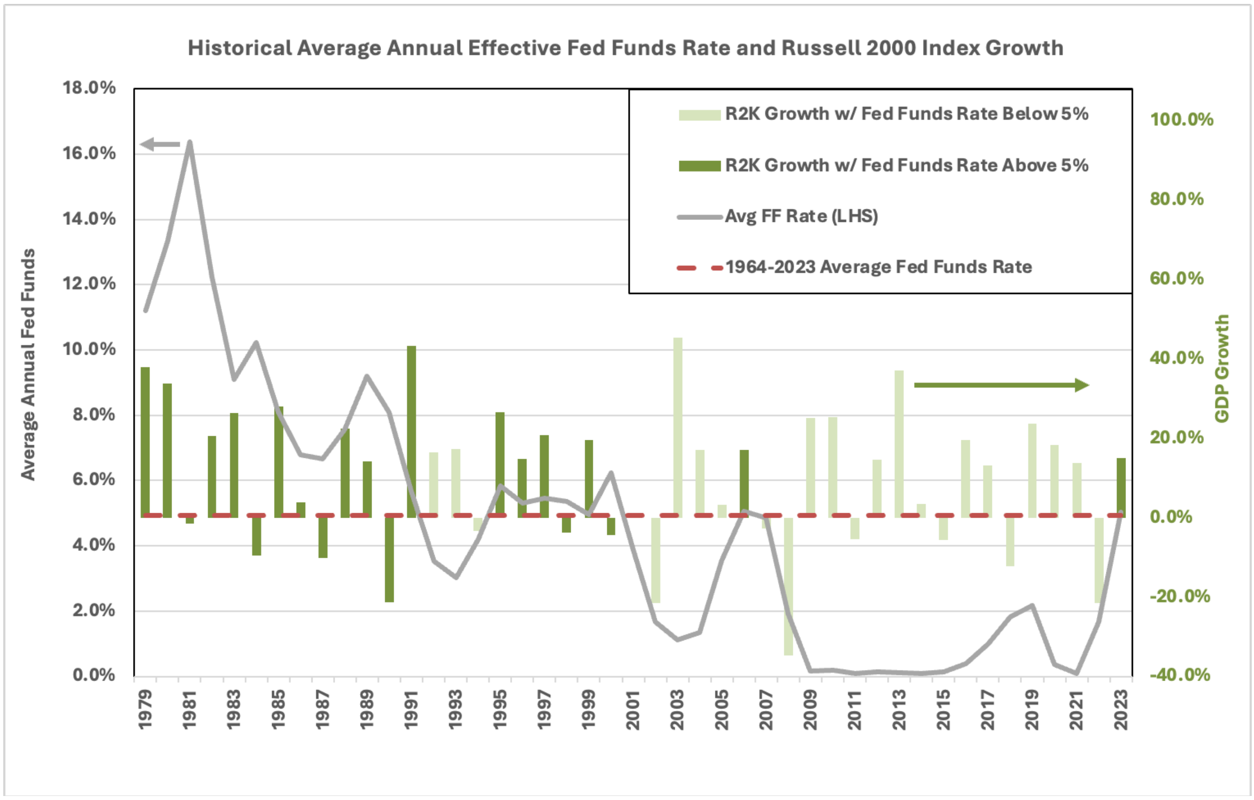
Source: Bloomberg

As shown above, the average fed funds rate for the entirety of the last 60 years is 4.9%, if one excluded 2009 to 2023 when rates were historically low, the average fed funds rate is 6.3%. Now let's overlay GDP growth during this period.



Source: Bloomberg

Over the past 60 years, there have been 31 years (or half the time), in which the fed funds rate was 4.9% or greater. The dark blue bars in the chart above show that the economy grew in 26 out of these 31 instances, or 84%. As, or perhaps more, interesting is that in the years where the fed funds rate was greater than 4.9%, the economy grew an average of 3.3%. In the years where the fed funds rate was less than 4.9%, the economy grew 2.9%. GDP growth doesn't tell the whole story, however, since it incorporates all parts of the economy. Let's dig in further and look at performance of small and microcapitalization public companies during these years versus Fed funds rates. One of the best proxies for this universe of companies is the Russell 2000 Index.



Source: Bloomberg

The Russell 2000 Index was down 14 years out of the last 45. In 8 of those 14 years, the Fed funds rate was less than 5%, while in 6 years the fed funds rate was 4.9% or higher. The number of times the Russell 2000 Index was up in each interest rate environment is approximately equal with 15 years of increases when Fed funds rates were greater than 4.9% and 16 times when it was less than 4.9%.

Reversion to Normal Isn't Bad News for the Economy or Stocks

If history is a guide to potential future outcomes, then the data presented above supports our view that the current interest rate environment of 5.25-5.50%, or anything close to it, should not be viewed as the end of the world. Rather it is a reversion to more normalized levels that historically have supported both strong economic growth and value creation in small and microcapitalization stocks. We believe this more normal interest rate environment is not likely to lead to a recession by itself. We believe the resiliency the economy showed in 2023 is more than capable of continuing into 2024. Therein lies what we believe to be the opportunity for investors, who like us, believe history will repeat itself and lead to meaningful value creation in this more normal environment, particularly for small and micro-capitalization companies.

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