PORTFOLIO STRATEGY

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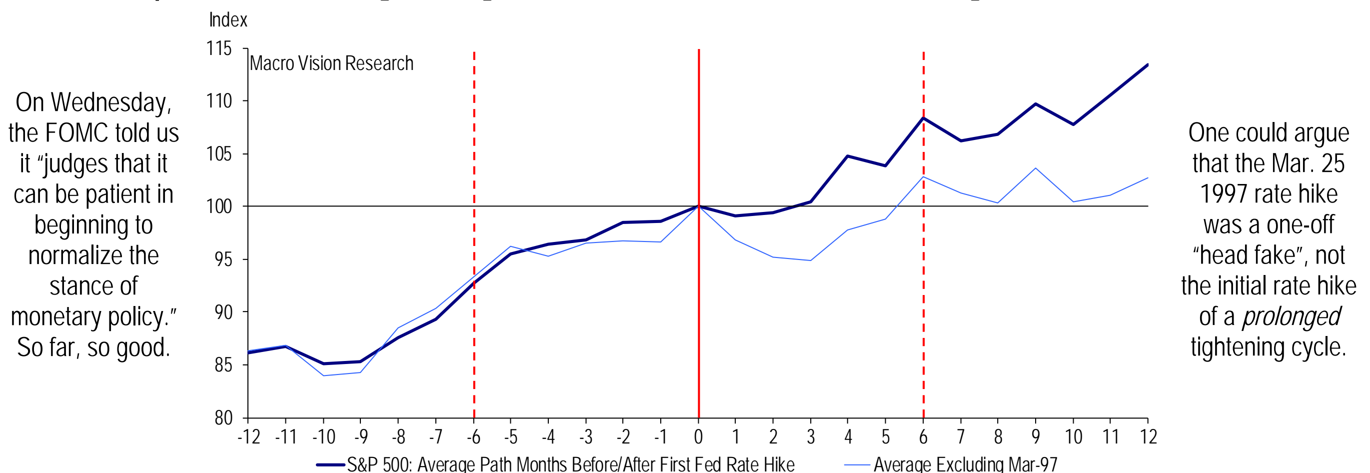
Don't be too spooked by Fed rate hikes

In our Jan. 17 2015 report entitled "*Targeting the S&P 500 in 2015 – assessing the risks around consensus (2,200)*" we framed the risks around share prices largely in terms of the timing and communication of the first Fed rate hike, given the historically *inverse* relationship between the Fed funds rate and the P/E ratio.

Last week, we discussed how significant market turmoil following the abrupt change in the SNB's exchange rate policy highlights the potential severity of the bearish scenario. However, the fallout from the SNB's surprise move also illustrates the value of a gradual and predictable exit from accommodative monetary policy, a lesson we hope that the Fed takes to heart. On Wednesday, the FOMC told us it "judges that it can be patient in beginning to normalize the stance of monetary policy." So far, so good.

Figure 1: Excluding the Mar-97 Fed rate hike, stocks rallied smartly in the 12- and 6-month periods before tightening reserve market conditions, but languished thereafter



Note: There's a range of opinions about when the Fed started targeting the federal funds rate. We focused our analysis on tightening reserve market conditions since 1990. Over the past 25 years, there've been four Fed tightening cycles beginning on Feb. 4 1994, Mar. 25 1997, Jun. 30 1999 and Jun. 30 2004, respectively.

This week, we thought we'd frame the debate in terms of the historical performance of share prices around the initial rate hike of *prolonged* Fed tightening cycles. There's a range of opinions about when the Fed stopped targeting the monetary aggregates and started targeting the federal funds rate (see the Aug. 2004 working paper "*When Did the FOMC Begin Targeting the Federal Funds Rate? What the Verbatim Transcripts Tell Us*" by Daniel L. Thornton of the Federal Reserve Bank of St. Louis).

We kept it simple by focusing our analysis on tightening reserve market conditions since 1990, which is well within the range of opinions about when the Fed started targeting the federal funds rate. Over the past 25 years, there've been four Fed tightening cycles beginning on Feb. 4 1994, Mar. 25 1997, Jun. 30 1999 and Jun. 30 2004, respectively. True, the sample size is small, but it's still a timely and relevant exercise.

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In figure 1, we plot the average path of the S&P 500 12 months before and after the first Fed rate hike of tightening cycles since 1990. One could argue that the Mar. 25 1997 rate hike was a one-off "head fake", not the initial rate hike of a *prolonged* tightening cycle. Either way, stocks rallied smartly in the 12- and 6-month periods before tightening reserve market conditions (read: easy money). Excluding the Mar. 25 1997 rate hike, stocks languished in the 12- and 6-month periods after the first Fed rate hike (read: the end of easy money).

Figure 2: Given the wide range of market expectations for the end of easy money, we calculated S&P 500 price returns 12 & 6 months before & after first Fed rate hikes since '90

If the first hike occurs around mid-year, the 6-month timeframe of our analysis may prove to be a useful guide for investors (i.e., 7%).

Date	12m Before	6m Before	6m After	12m After
02/04/94	10%	7%	3%	-2%
03/25/97	17%	10%	16%	46%
06/30/99	21%	12%	-1%	6%
06/30/04	17%	3%	-2%	4%
Max	21%	12%	16%	46%
Mean	16%	8%	4%	13%
Mean Ex Mar-97	16%	7%	0%	3%
Min	10%	3%	-2%	-2%

If the first hike occurs around year-end, the 12-month horizon might be a more helpful benchmark (i.e., 16%).

Note: Our analysis is based on closing values at month-end. For the 02/04/94 and 03/25/97 Fed rate hikes, we measured S&P 500 performance around the close on 01/31/94 and 03/31/97, respectively.

In our Jan. 17 2015 report, we discussed how FOMC participants seem to be increasingly certain that policy will firm this year, as the number of participants (15) is clustered around 2015. While Fed rate hikes are coming, the *exact* timing of the first hike remains unclear. Given the wide range of market expectations for the end of easy money, we calculated S&P 500 price returns (%) in the 12- and 6-month periods before and after the first Fed rate hike of tightening cycles since 1990 (figure 2).

If the first hike occurs around mid-year, the 6-month timeframe of our analysis may prove to be a useful guide for investors (i.e., 7%). In that case, the average S&P 500 return (excluding the Mar. 25 1997 rate hike) was remarkably consistent with the consensus expectation (e.g., an S&P 500 outcome of 2,200 or 7% y/y in 2015). If the first hike occurs around year-end, the 12-month horizon might be a more helpful benchmark (i.e., 16%). In that case, the average S&P 500 return (excluding the Mar. 25 1997 rate hike) was in line with our upside risk scenario (e.g., an S&P 500 outcome of 2,400 or 17% y/y in 2015). You be the judge.

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