Getting Closer: Fed Continues its Tapering & Moving Toward Rate Hikes

By Liz Ann Sonders - July 30, 2014

Key Points

- Fed continues its taper; moving closer to rate hikes
- Strong GDP report elevating chatter about possible earlier-than-expected rate hikes
- Although volatility/pullbacks are possible, history shows initial rate hikes are NOT negative for stocks

The Federal Reserve did as expected and trimmed another $10 billion from their Treasury and Mortgage-Backed Securities (MBS) purchases associated with quantitative easing (QE). The Fed is now buying $25 billion per month, down from $85 billion at QE's peak. This puts "tapering" on track to end in late-October as the Fed's been telegraphing. Because Fed Chair Janet Yellen has mentioned that rate hikes could begin as soon as six months following the end of tapering, the market is expecting rate hikes to begin sometime in the middle of 2015.

There was one dissenter among the voting members of the Federal Open Market Committee (FOMC): Philadelphia Fed President Charles Plosser. He "objected to the guidance indicating that it likely will be appropriate to maintain the current target range for the federal funds rate for 'a considerable time after the asset purchase program ends,' because such language is time dependent and does not reflect the **considerable economic progress that has been made toward the Committee's goals**." (Emphasis mine.)

Strong Q2 GDP report

Today's stronger-than-expected report on second quarter gross domestic product (GDP) has heightened concerns that the Fed will be prompted to move sooner. In the initial report, real (inflation-adjusted) GDP was up 4% for the second quarter; while the first quarter was revised from -2.9% to -2.1%. The prior two quarters were revised up meaningfully as well. This is a notable improvement. But in the eyes of Yellen it would likely need to be confirmed by additional data—notably stronger job growth and a further deceleration in the unemployment rate, given that the Fed's mandate(s) is not around GDP, but around employment (and inflation).

Speaking of the Fed's mandates

The Fed—unique among global central banks—has a dual mandate: "full" employment and stable prices (inflation). So, it's instructive to see where we are relative to both. In today's statement that accompanied the Fed's decision, it was noted that, "…labor market indicators and inflation (are) moving toward the levels the Committee judges consistent with its dual mandate."

The Fed's suggested natural rate of unemployment is 5.4% (we are at 6.1% presently). The Fed's target inflation rate is 2% (we are at 1.8% presently, based on the Fed's preferred measure, the PCE).

We are getting close to both. When we were at similar spreads in 1994, the Fed had been tightening for six months already; and in 2004 they had been tightening for a year already. That said, given the post-financial crisis era in which the Fed's been navigating, it's not unexpected that they'd give it more leeway this time.

Rate hikes and stock market

What I want to do in this report is start the conversation around the impact a rate hike cycle tends to have on the stock market. This will undoubtedly be a topic we tackle often and in various forms over the next year; both on the equity and fixed income side. For now let me start with some of the dominant questions I'm hearing from investors in my travels.

The first and most obvious one is about the impact of Fed policy on the stock market; especially given the assumption that extremely loose monetary policy has been a significant prop under stocks. The debate will go on for some time as to how much of this 5½ -year bull market is a function of the Fed's zero interest rate policy (ZIRP); but throughout history, easy monetary policy has nearly always been a strong prop for stock markets. Frankly, that's why my first boss—the late, great Marty Zweig—coined the phrase "don't fight the Fed."

Four phases of monetary policy

In a recent report by Bank Credit Analyst (BCA) Research they highlighted the four phases of a monetary policy cycle based on the interaction between the level of rates and their direction. Policy is deemed to be easy if the fed funds rate is below its equilibrium level (Phases I and IV), and tight if it's above that level (Phases II and III). You can see the four phases, and the accompanying stock market performance, in the table below.

S&P 500 returns during rate cycle phases (from August 1961)

	S&P 500 CAGR		
	Mean	Median	# of phases
Phase I (easy, hiking)	10.6%	6.8%	8
Phase II (tight, hiking)	2.5%	6.2%	9*
Phase III (tight, cutting)	-8.7%	-9.1%	6*
Phase IV (easy, cutting)	23.2%	18.2%	8*
Easy (phases I and IV)	16.9%	7.6%	16
Tight (phases II and III)	-2.0%	-0.4%	15

Source: BCA Research Inc. *Table excludes Phase III (July '95 to September '98) and Phase IV (April '01 to May '04) incidences distorted by the dot-com bubble. If they were included, Phase III's mean and median CAGRs (compounded annual growth rate) would be -4.4% and -1.1%, respectively, over 7 incidences and Phase IV's would be 20.3% and 9.2% over 9 incidences. The 2-month Phase II incidence spanning the October '87 crash (-80% CAGR) has also been excluded.

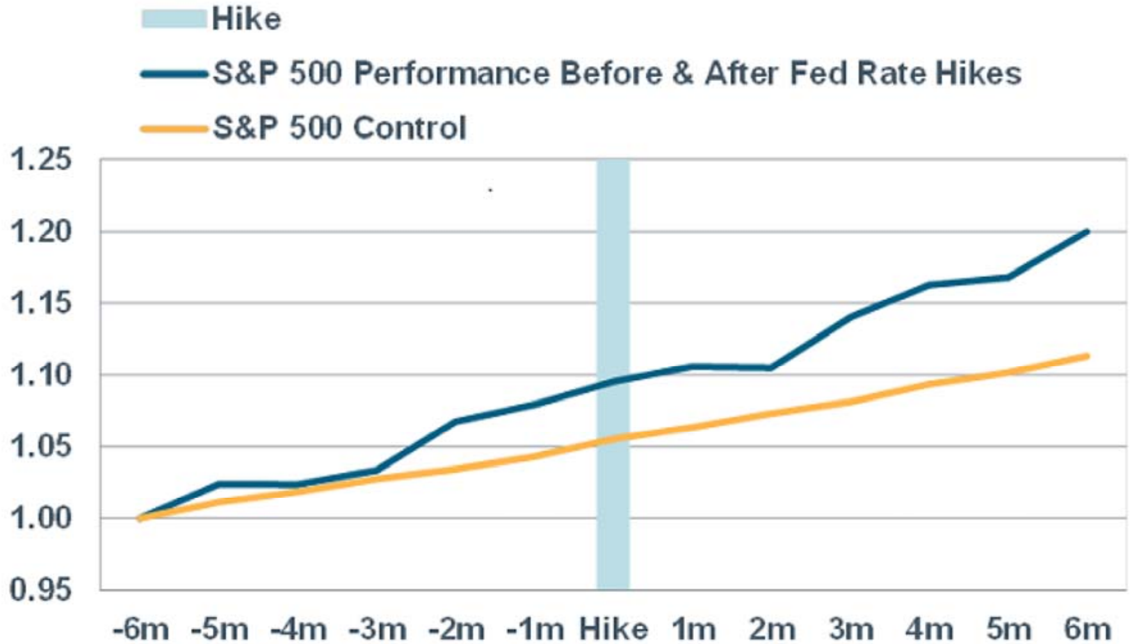
We have been in Phase IV since January 2008 and will remain there until the first rate hike. As noted by BCA, the durations of Phase IV and Phase I are significant because the level of rates (easy or tight) has trumped their direction (lower or higher) when it comes to explaining S&P 500 returns. In fact, all of the stock market's returns in the past 50-plus years were achieved when monetary policy was easy.

Pullbacks have been mild historically

It is common to experience some volatility and initial pullbacks when moving toward the initial rate hike. In looking at the past five rate hike cycles, the average pullback—nearly always having concluded before the actual first hike—was less than 6%, therefore not even qualifying as a "correction," which is -10%. The magnitude of the pullback was directly tied to the magnitude of the back-up in two-year Treasury yields. So keep an eye on those as we approach the initial rate hike.

Overall, the stock market fares pretty well in the six months before and after the initial hike, especially relative to what the S&P 500 has done in other same-length spans, as you can see below.

Market Performance Around Initial Rate Hike



Source: ISI Group. First hike in rates following a period of either declining or flat rates is considered a cycle. Each six months after, if the Fed was still hiking ISI included that period as a new cycle. This increased the sample size, which would otherwise be extremely small if only initial hikes were used. S&P 500 Control represents the performance of the market over non-overlapping 6-month periods during the tested time frame (1982-2006).

Another concern I've been hearing is that rate hikes are warning sign of a pending bear market and/or recession (with the former nearly always preceding the latter). I think it's quite premature to be fretting about either. You can see the history of initial rate hikes and the span between those and both bear market and recessions. On average, it was 16 months before a bear market began and fully two years before a recession began; not to mention the fact that not every rate hike cycle has preceded either a bear market or a recession.

Fed tightenings ahead of bear markets and recessions				
Date of first Fed rate hike	Bear market start	# of months to bear market	Recession start	# of months to recession start
4/15/1955	8/2/1956	16	August 1957	28
9/12/1958	12/12/1961	39	April 1960	19
7/17/1963	2/9/1966	31	n/a	n/a
11/20/1967	11/29/1968	12	December 1969	25
1/15/1973	1/11/1973	0	November 1973	10
8/31/1977	n/a	n/a	January 1980	29
9/26/1980	11/28/1980	2	July 1981	10
9/4/1987	8/25/1987	-1	July 1990	34
2/4/1994	n/a	n/a	n/a	n/a
6/30/1999	3/24/2000	9	March 2001	21
6/30/2004	10/9/2007	40	December 2007	42
	Mean	**16**	**Mean**	**24**
	Median	**12**	**Median**	**25**

Source: Ned Davis Research, Inc. (Further distribution prohibited without prior permission. Copyright 2014(c) Ned Davis Research, Inc. All rights reserved). Bear market defined as drop of 20% or more in the S&P 500.

In sum

The statement accompanying the Fed's decision was read as a touch more "hawkish" than in the past, which was likely done to cement the notion that the Fed is on a path toward raising rates by mid-2015. The economy is making clear progress and the Fed is moving toward rate hikes and monetary policy normalization. This, by the way, is a good thing.

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