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Equities during a Fed Tightening Cycle

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IT HAS BEEN ALMOST SEVEN YEARS since the Federal Reserve lowered its benchmark federal funds rate to near 0% to combat the Great Recession. With various economic data continuing to show marked improvement from the depths of the crisis, particularly surrounding unemployment, the Fed now seems poised to start down the path of interest-rate normalization after a long period of ultra-loose, unorthodox monetary policy.

We don't think it's an exaggeration to call the Fed's monetary policy during the global crisis "The Greatest Financial Experiment in Modern History." The economic downturn had brushed off all of the Fed's traditional tools to stem the slide, forcing the Fed to attempt increasingly unconventional policy measures while fearful investors continued to ask themselves, "Will this work?" Ultimately, they did, but not without a dark cloud of uncertainty. Now, with the Fed about to embark on its first interest-rate tightening cycle in more than 11 years, uncertainty has returned as we continue the path back from unchartered territory.

Financial markets hate uncertainty. Uncertainty begets volatility. If history serves as a guide, this first rate hike should provide elevated volatility for equity investors, but, all else equal, it shouldn't be the sole catalyst for a new bear market.

Legitimate Investor Concerns

To be sure, an increase in the fed funds rate (and its direct impact on other key interest rates) will be a watershed moment for this business cycle. Investors are right to be cautious and thoughtful about the implications for equities:

- *If the Fed tightens too much or too quickly, it risks choking off economic growth.* Debt (i.e., credit) is the lifeblood of economic growth, and interest rates are the cost of credit. If the cost of credit becomes too burdensome, companies and individuals will demand less or become unable to repay some of their current debt.
- *Higher interest rates could make debt investments relatively more attractive than equities.* When interest rates rise, the yield earned by bondholders increases. Income investors that are agnostic to the source of income may seek relatively higher income from bonds in lieu of dividend-paying stocks.
- *Higher interest rates should pressure companies' profits.* As companies look to take on new debt for investments or refinance current loads in a rising-rate environment, the increase in interest expense should reduce their profitability, all else equal.
- *Financial theory suggests higher interest rates should reduce the current value of equities.* All else equal, higher interest rates lead equity investors to require a higher rate of return on their stocks (assuming the return premium they demand over interest rates on risk-free government bonds remains constant), pushing down the initial price an investor would pay in order to achieve his desired rate of return.

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Historical Equity Performances after Initial Rate Hikes

To the likely surprise of some, equities have performed reasonably well when measured over appropriate time periods around past initial rate hikes. Exhibit 1 shows the price return (which conservatively excludes the positive impact of reinvested dividends) of the S&P 500 for various time periods before and after past initial tightenings, beginning with former Chairman Alan Greenspan's Fed.

EXHIBIT 1: ***S&P 500 Returns Around Initial Fed Rate Increases***

S&P 500 Price Returns Around Intial Fed Rate Hikes (%)								
Months Before Hike					Months After Hike			
				Date of				
-12	-6	-3	-1	Intial Rate Hike	+1	+3	+6	+12
-12.2	-19.5	5.9	-0.9	3/29/1988	1.3	5.0	5.6	13.3
5.1	4.8	1.5	0.9	2/4/1994	-3.3	-6.0	-4.6	-0.4
20.6	10.5	4.8	5.4	6/30/1999	-1.7	-5.1	8.4	7.6
16.9	2.8	1.6	1.8	6/30/2004	-3.0	-1.9	6.8	4.9
7.6	-0.4	3.5	1.8	Average	-1.7	-2.0	4.1	6.4

Source: Morningstar Direct, Clayton Financial Services, Inc.

We can draw several conclusions from the data. First, equities generally performed well leading up to initial rate hikes.[1] For short periods following the hike, equity markets struggled somewhat as investors digested the event and attempted to ascertain the path ahead. But, importantly, equities regained positive returns just six months after the hike, on average.[2] Ultimately, history suggests than the next rate hike will be far from catastrophic.

This Time It's Different

The late, great investor Sir John Templeton once famously said, "The four most dangerous words in investing are 'This time it's different.'" Naturally, we hesitate to use such a phrase here, but we feel it's applicable for two distinct reasons.

We use the phrase to highlight the uniqueness of this interest-rate cycle. The first rate hike will be the Fed's first step at unwinding its unprecedented "zero interest-rate policy." The significance of this effort is enough to lay the foundation for increased volatility, in our opinion, and investors should brace themselves for a bumpy ride.

Differently, the phrase also lays the foundation to alleviate some of the investor concerns highlighted earlier. Specifically, we are approaching this "lift-off" from a much different starting point than other tightening cycles.

- *Here, "tightening" doesn't mean "tight."* Current Fed Chairwoman Janet Yellen has pointedly stated that once the Fed begins to raise its target rate, it will be very cautious, implying the possibility (if not likelihood) the Fed will pause hiking between meetings—a stark contrast from the steady 25-basis-point hike per meeting during the previous

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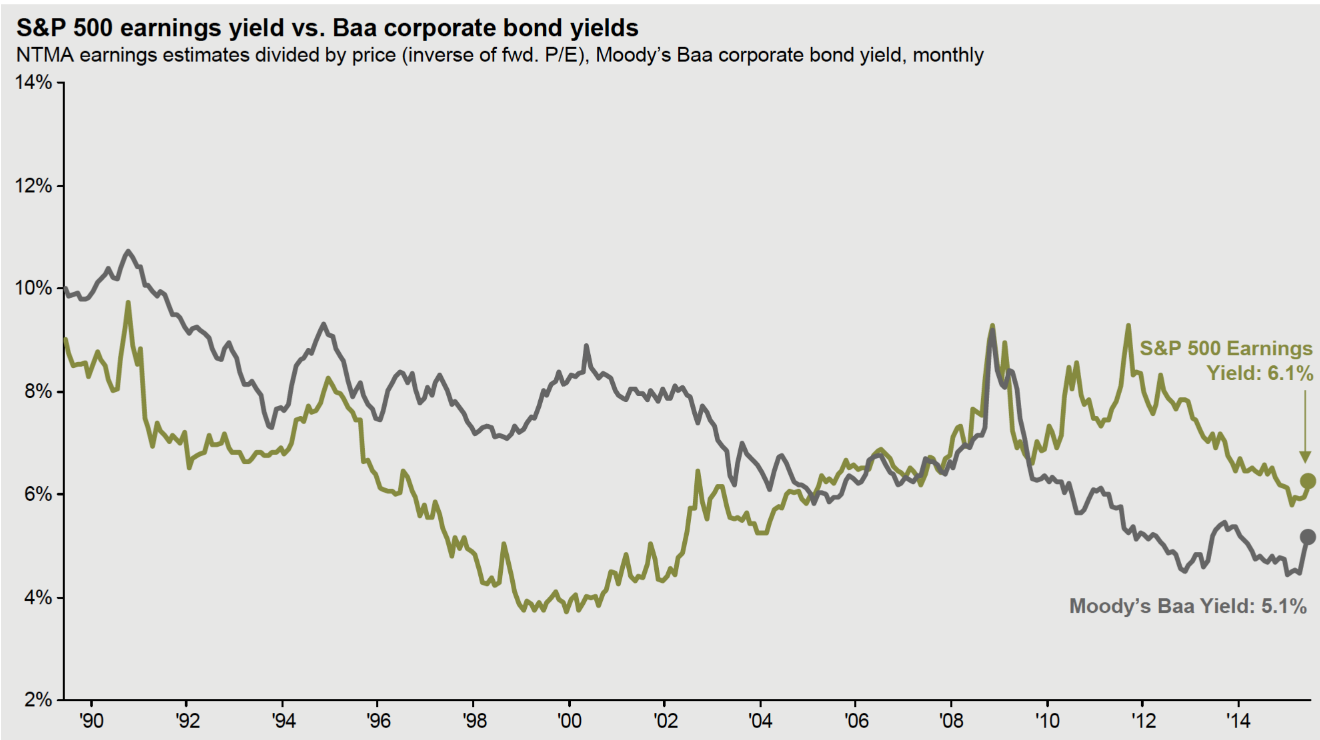
tightening cycle. Further, a starting fed funds rate of near 0%, coupled with headline inflation between 1% and 2%, suggests a continued *negative* real (i.e., inflation-adjusted) fed funds rate for some time—which to us is far from "tight" conditions.

- *Yield measures for stocks remain more attractive than for bonds.* Exhibit 2 compares the historical earnings yield on the S&P 500 with the interest yield on investment-grade corporate bonds. Note that BAA bond yields remain near decades-low levels and below current S&P 500 earnings yields, highlighting a relatively more attractive valuation for stocks.

EXHIBIT 2: *Historical Earnings Yields vs. Bond Yields*



Source: Standard & Poor's, Reuters, FactSet, FRB, J.P. Morgan Asset Management. Earnings yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price). Guide to the Markets – U.S. Data are as of June 30, 2015.

- *Increases in interest-rates from relatively low levels suggest an improving economic outlook and have historically been favorable for equities.* Exhibit 3 highlights the historical correlation between equity returns and changes in interest rates. The positive relationship between stock returns and higher rates has remained intact until the yield on 10-year Treasurys reaches about 5%. Given our outlook for a more modest rate of economic growth under normal conditions than in the past, we expect that this yield "breakpoint" will be somewhat lower than 5% going forward. But with the current 10-year yield of less than 2.5%, we think equities c an still benefit from this association.

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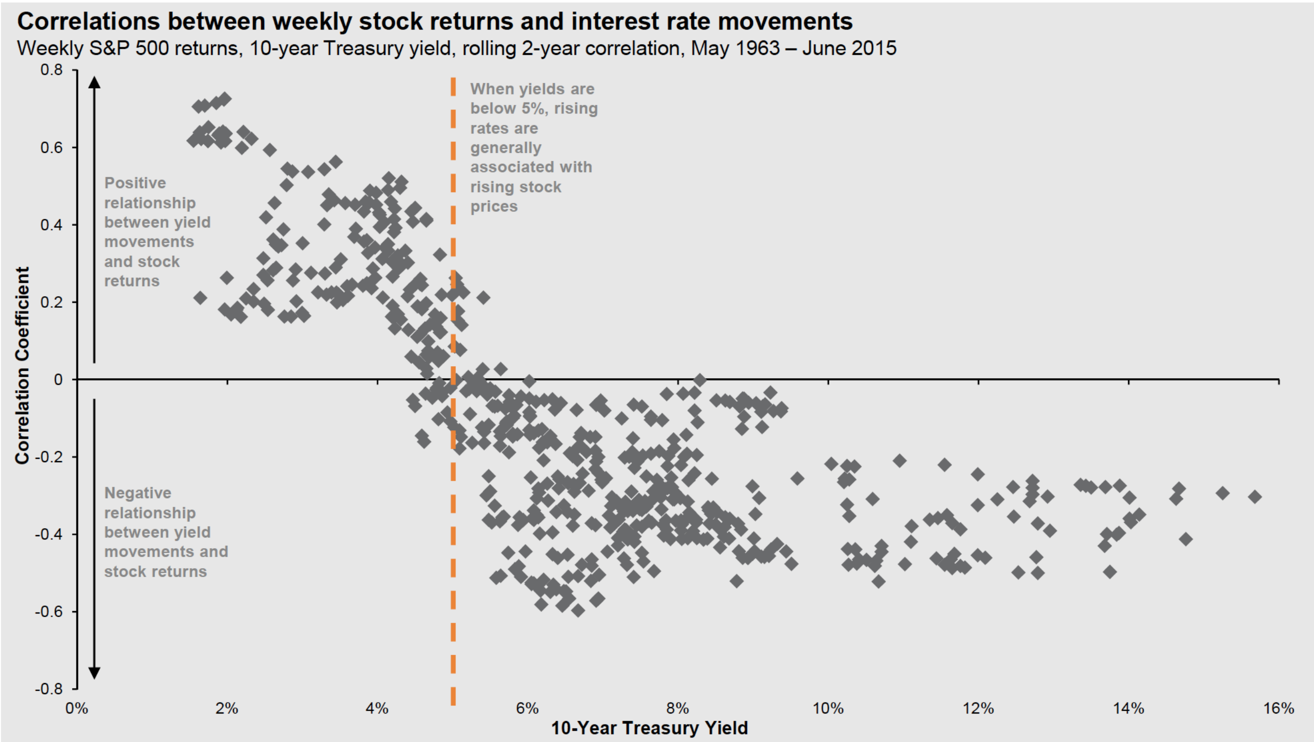
Exhibit 3: *Correlations between Equity Returns and Changes in Interest Rates*



Source: FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.
Guide to the Markets – U.S. Data are as of June 30, 2015.

Summary

Contrary to some popular belief, an initial Fed interest-rate increase (or rising interest rates, in general) does not automatically sound the death knell for positive equity returns. While previous rate hikes have led to increased volatility and short-term pressure on equities, equities have historically performed reasonably well when considered over an appropriate time period.

Given the uniqueness of this current/upcoming tightening cycle, additional uncertainty may lead to even further near-term volatility. But we continue to favor the long-term prospects of stocks over bonds at this time.

NOTES

1 The exception was the period before the March 1988 rate increase that included the Black Monday market crash in October 1987. The stock-market correction in late summer 2015, which has been attributed largely to concerns about China's economy and financial markets, will likely be another exception. In both instances, the primary catalyst was something other than an increase in the fed funds rate.

2 Of the four data points observed, only the rate increase in 1994 was associated with negative equity returns six months out; this tightening cycle was unique in that Fed Chairman Greenspan blindsided the markets with the increase.

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