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WHAT REALLY HAPPENS WHEN THE FED STOPS TIGHTENING?

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What Really Happens When the Fed Stops Tightening?

"Reality is only an illusion, albeit a very persistent one." – Albert Einstein

Perception is reality in financial markets. Thus, as a swelling number of traders and investors have cottoned to the idea that stocks soar at the end of a Fed tightening cycle, weak economic stats have been greeted with rallies, while stronger data have generally led to sell-offs. Indeed, markets exploded on April 18 after minutes from the March Fed meeting were released, as they reported a majority of members "thought that the end of the tightening process was likely to be near." Yet while the *theory* that stocks rally after the Fed has finished tightening has become widely accepted of late, this is at odds with the historical evidence (Table A). Since 1920, there have been 16 periods when the Fed has hiked rates at least two times in succession: in 12 cases, equities have been lower six months after the final hike, and in nine cases they have been lower a year after the last increase. This inauspicious record, coupled with the swelling investor ranks expecting a rally (not to mention valuation multiples at the high end of historical ranges despite record profits), gives us a good deal of pause when assessing prospects for the U.S. equity market.

The concept that the end of a Fed tightening cycle is good for equities seems to be based largely on what happened in 1995, when the market took off shortly before the last rate hike in February and continued climbing for the rest of the year and decade. This period, however, represents the exception rather than the rule. In fact, the market has historically *fallen* after the last rate hike, with losses during the 16 periods studied averaging nearly 5% over the subsequent six months. Even if we exclude the two periods that occurred during the Great Depression (on the grounds that they represent outlier periods, both in terms of economic conditions and market outcomes), equities still fell an average of 2% over the six months following the last Fed hike. Indeed, it is only when the Fed has begun to cut rates again that markets have risen. Work done by Ned Davis Research, for example, shows that when dealing with Fed policy cycles, the optimal time to buy equities has historically been after the first two rate cuts of an easing cycle. Indeed, Table A shows that equities have typically bottomed about ten months after the last rate hike; since 1962, the Fed has shifted from hiking to easing eight times, with nine months on average elapsing between the last hike and the first cut.

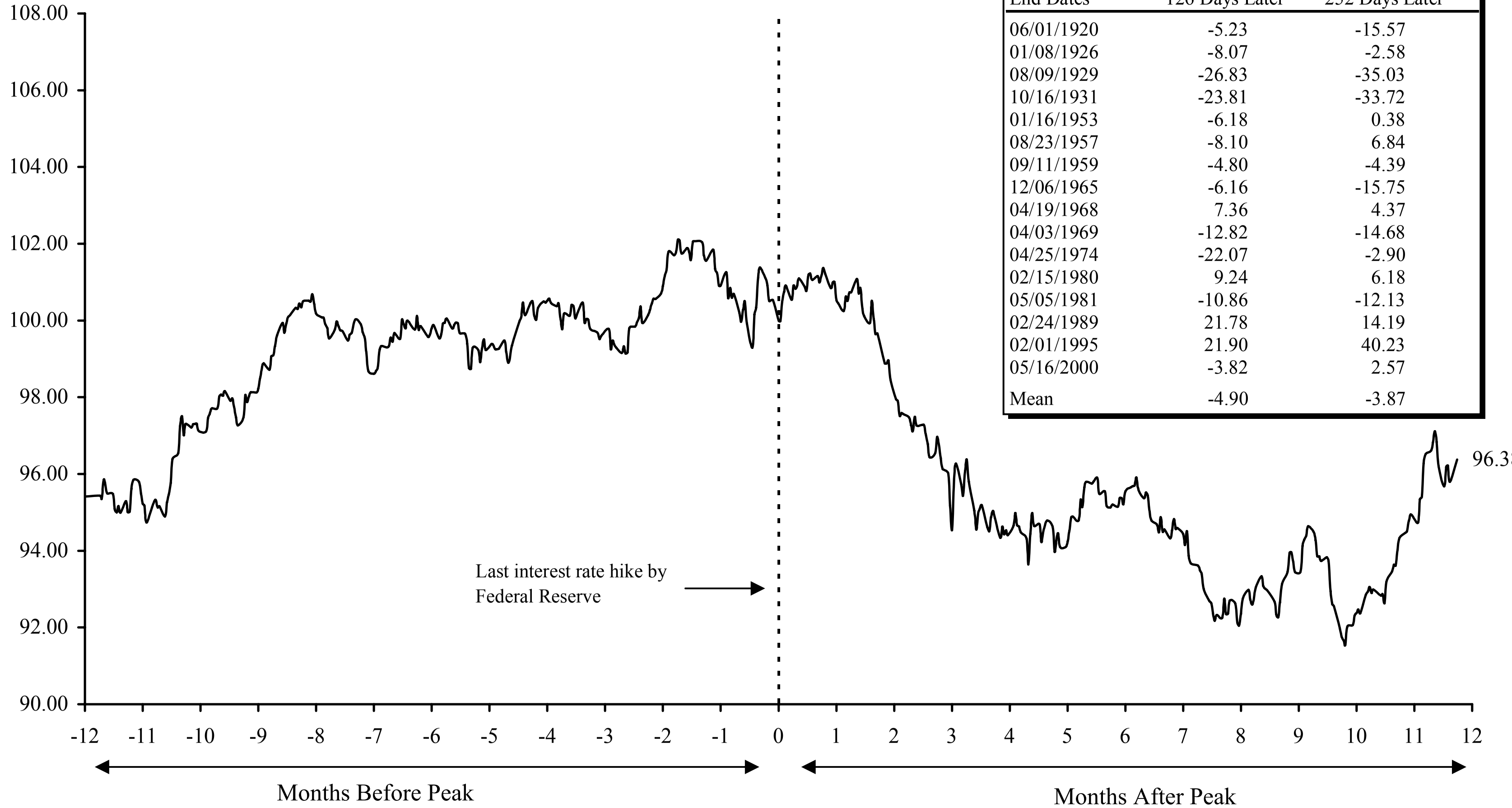
We would also note that the Fed rate cycle is but one factor among many influencing markets. Indeed, the U.S. economy (and thus corporate profits) benefited from several strong tailwinds during the mid- to late 1990s, including (but not limited to) the rapid proliferation of new technologies (most notably through the commercialization of the Internet), the fruits of the wave of corporate restructuring that crested in the late 1980s/early 1990s, the fall of Communism (with all that entailed), a sustained period of global peace, and rapid money creation by the Federal Reserve. Price-to-earnings (P/E) multiples, meanwhile, were reasonable. Thus, the contribution of the end of Federal Reserve tightening to the performance of the U.S. equity market in 1995 likely paled in comparison to the raft of favorable conditions that persisted and drove strong performance for the next five years.

Today's environment, by contrast, could hardly be more different. While the economy in 1995 was on the cusp of a boom, and equity prices at roughly fair value, we are now on the opposite side of perhaps the biggest bubble in financial history, the excesses of which have yet to be fully cleared, while equities are priced for economic nirvana (i.e., strong profit growth and low inflation). U.S. consumers have ratcheted up debt loads to previously unimaginable levels, while corporations, on the other hand, have stubbornly refused to step up capital expenditures despite consistent predictions that they will imminently do so. Thus, the growth the U.S. economy has seen in recent years has not only been of the low-quality kind (i.e., driven by consumer purchases and government spending rather than corporate investment), but has also been financed largely by debt, pushing up household liabilities and the fiscal deficit. Globally, the United States is now engaged in two major military efforts (Afghanistan and Iraq), and tensions with Iran continue to build rapidly. Despite all this, earnings growth has outpaced that of stock prices, causing P/Es based on trailing reported earnings to come down considerably, although at multiples of 18x earnings they are still high, particularly since corporate profits are setting all-time records and likely close to a cyclical peak. Indeed, earnings growth of the S&P 500 has been decelerating since the end of 2003. Normalized P/E ratios, which smooth earnings, are higher than *at any time* before 1997.

Given all this, why have markets become so enamored of the “rally when the Fed is finished” thesis? While we cannot know for sure, the simple and somewhat commonsensical nature of the argument (i.e., *ceteris paribus,* lower or stable interest rates make equities more attractive than do higher rates), coupled with the strong rally that followed the conclusion of the last two periods of Fed tightening, particularly during 1995, certainly gives investors something to latch onto, while the frothiness of the current environment has likely emboldened speculators in general. The “why” is not so important, however, as the fact that so many market participants seem to believe so fervently in the story. While we certainly cannot predict what markets will do in the short term, the unique nature of the current market environment (i.e., high multiples and extremely complacent investors alongside a very unsettled global environment, both politically and economically) makes equities more susceptible than normal to some sort of exogenous event. The strong consensus that the Fed is almost done tightening, and particularly that the end of the tightening cycle will benefit equities, brings out our contrarian bent. Indeed, while it is far from clear that equities would benefit from an end to the rate hike cycle (at least initially), there is also the risk that the Fed will continue to tighten beyond current expectations, which would not only surprise markets, but would also drain liquidity and hit risky assets especially hard. Thus, investors should continue to play good defense by diversifying, favoring non-U.S. assets, especially with regard to equities, and *rebalancing*.

Table A

DOW JONES INDUSTRIAL AVERAGE AROUND LAST FEDERAL RESERVE INTEREST RATE HIKE



Fed Tightening End Dates*	DJIA Change (%) 126 Days Later	DJIA Change (%) 252 Days Later
06/01/1920	-5.23	-15.57
01/08/1926	-8.07	-2.58
08/09/1929	-26.83	-35.03
10/16/1931	-23.81	-33.72
01/16/1953	-6.18	0.38
08/23/1957	-8.10	6.84
09/11/1959	-4.80	-4.39
12/06/1965	-6.16	-15.75
04/19/1968	7.36	4.37
04/03/1969	-12.82	-14.68
04/25/1974	-22.07	-2.90
02/15/1980	9.24	6.18
05/05/1981	-10.86	-12.13
02/24/1989	21.78	14.19
02/01/1995	21.90	40.23
05/16/2000	-3.82	2.57
Mean	-4.90	-3.87

Source: Ned Davis Research Group.

Note: Graph represents daily data starting in 1920 and 12 months is equivalent to 252 market days.
* At least two consecutive rate increases before a decrease.