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Fed Rate Hikes Don’t Have to Kill the Rally

The first major initiative from the new administration, healthcare reform, is running into the usual partisan resistance — as well as intra-party sniping from both conservatives and moderates. While intra-party resistance is less common than other-party opposition, the difficult path ahead for legislation of this magnitude is nothing out of the ordinary. Politicians and ordinary citizens may see this process as politics as usual.

For stock investors, on the other hand, the gridlock threatening to become inertia has to be unsettling. The market has run up more than 13% from the early November low on the perception that the new president’s agenda would provide a major boost to the economy and to businesses. If the process is bogged down, recently inflated stock valuations may begin to look unsustainable.

Yet stocks continue their blithe run higher. The Trump rally is grinding along, and that may be the key to its longevity. According to LPL Financial, the stock market has gone 104 days without a 1% drop, the longest such streak for the S&P 500 since 1995. Our daily rate of change indicator suggests that the bull is quietly moving higher, ignoring all the clamor from Washington while focusing on the positive fundamental outlook

We chart daily rate of change (DRC) in the S&P 500 to get a sense of near-term volatility; this metric also provides color on whether one camp (bull or bear) is in charge, or if the market is experiencing a heated tussle between the two camps. Our analysis has shown that in periods of high DRC, bulls and bears are evenly matched and market returns (either up or down) tend to be muted. In low DRC phases, either the bears or (more often) the bulls have the upper hand; the market grinds higher most days; and period returns are above average.

In the 2007-11 period, when the annual price change on the S&P 500 averaged 0.3%, DRC was 1.12. In 2012-16, when the annual price change averaged 12.6% on the S&P 500, DRC was 0.59. Our DRC analysis shows another mild year for volatility in 2017. With stocks up 5.9% YTD, DRC to date in 2017 is 0.32%, much tamer than the 0.59% rate for all of 2016 and the 0.82% average for 2006-16.

The message here is that “quiet bulls are productive bulls.” But can the bull stay quietly productive even in the face of rate hikes by the Federal Reserve?

THE FED AND THE STOCK MARKET

As we went to press, the Federal Open Market Committee (FOMC), the policy-setting arm of the Federal Reserve, was about to begin its mid-March meeting. Fund futures have expressed near unanimity about the likelihood of a rate hike at this meeting. The 3-month yield was at 0.44% little more than a month ago, when most investors expected the first rate of the year to take place in June. Based on solid economic data, rising signs of inflation and Fed governors talking about the need to raise rates, the 3-month bill yield rose steadily through the 0.68% range into the end of February before spiking to 0.74% early in March.

Commentary from Fed Chair Janet Yellen provides little reason to doubt that the Fed will hike interest rates three times this year. Coupled with the “orphan” rate hikes in December 2015 and December 2016, we are on track to exit 2017 with the central tendency in the Fed funds rate in the 1.25%-1.50% range. While those rates are not historically high, that is still quite a change from the 0.0%-0.25% central tendency prevailing before the Fed began the current round of more-restrictive monetary policy.

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How do stocks fare in periods in which the Federal Reserve is hiking rates? The short answer is, not bad, particularly at the beginning of the rate cycle. But eventually, as the cycle matures, stock returns slip below average.

To get a sense of how stocks behave during (and just before) the Fed's rate cycles, we collected data on Fed hiking cycles since 1980 and analyzed them against S&P 500 returns over those periods. Since 1980, and not including the current cycle that began in December 2015, the Fed has embarked on five rate-hiking cycles. Those cycles occurred from February '83 to August '84; March '88 to March '89; December '93 to March '95; June '99 to July '00; and June '04 to Aug '06. [In retrospect, those last two cycles seem poorly timed, given the stock market declines that began in 2000 and 2007.]

On average, these cycles have lasted 16.8 months. The longest cycle began in June '04; the shortest began in March '88. The average rate hike across the cycle was 310 basis points (bps). Rates were hiked the most in the cycle begun in June '04 (425 bps) and the least in the cycle begun in June '99 (185 bps).

Rate cycles, by the time they begin, are well anticipated; but investors do not act fearful in advance. For the six months preceding the five cycles noted above and up to the first rate hike, the S&P 500 averaged a return of 6.1%. On an annualized basis, that roughly 12.2% gain is a bit better than average annual capital appreciation of 9.7% on the S&P 500 since 1980. However, there is broad dispersion of returns for these six-month pre-hiking periods. The best six-month showing came in 1983, with a 31% surge; the worst started in 1988, when stocks went down 17% in the six months preceding the rate cycle.

Once the hikes are actually underway, stocks perform about as normal — though again there is fairly wide dispersion of returns. For the period between the first rate hike and the six months after, the S&P 500 averaged capital appreciation of 4.7%. This includes a 13% gain in the six months following commencement of the February '83 rate cycle; and negative return of -3.3% in the March '88 cycle.

We mentioned that the average rates cycle has lasted 16.8 months. Average capital appreciation across these five rate cycles has been 9.2%. On an annualized basis, that equates to approximately 6.6% full-year capital appreciation. That is about 310 bps below the average annual return of 9.7% on the S&P 500 since 1980. The fact that 310 bps is also the average cumulative rate hike for each cycle is purely a coincidence, though it does make one go "hmmm." The bigger takeaway is that — given stronger performance early in the rate cycle (first six months) — stocks really lag in the final six to 12 months of the cycle.

CONCLUSION

The poor stock performance late in the cycle likely is related less to the Fed's actions in and of themselves and more to the fact that the Fed, if still hiking, is likely trying to stop or restrain inflation. Stock returns are much more vulnerable to inflation itself than to the Fed's weapon against rising prices. The Fed is acting now, in our view, not because unemployment has reached some magic number (arguably unemployment was at the Fed's target two years ago) but because CPI and particularly PPI pipeline data is sending worrisome signals about inflation.

As noted, stock investors do not appear concerned. The S&P 500 is down about 1% from its peak in early March. We are neutral on the stock market from a purely technical perspective, after being technically bullish for the past nine months.

Weakness in breadth triggered our more cautious near-term stance. Amid the distractions from Washington, we recommend not losing sight of breadth. Were the advance to become too thin and limited to a few high-profile names without confirmation from a broader basket of stocks, the market may be signaling readiness to topple over.

Stocks are likely overdue for a correction, and not necessarily of the one-day variety. Stock markets tend to experience several single-digit cumulative corrections in the course of any trading year. In our view, it is best to regard such events as a given. As always, we would focus on high-quality names, as those are best-positioned to hold value during and after any adverse market event. We would be particularly focused on quality should a non-fundamental event (a broad market correction) enable investors to buy those stocks at lower valuations than they currently command.

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