Initial Fed Rate Hikes: Effects on Equity Markets

December 23, 2015

This article is provided by the Wealth Management Division of Bryn Mawr Trust.

In one of the most expected and discussed Fed actions, the Federal Reserve finally raised short-term interest rates 25 basis points (0.25%) on December 16. The last rate hike by the Central Bank was almost 10 years ago, in 2006.

The possibility of an interest rate increase has been a major source of market "angst" and financial news for the past year or so. Discussion of a rate hike accelerated this summer and fall, as domestic economic growth improved in the wake of unprecedented liquidity measures instituted by the Federal Reserve after the financial "meltdown" of 2008-09.

It is often assumed that the onset of higher short-term interest rates due to changes in monetary policy causes equity prices to decline. Conversely, a decline in short-term interest rates is usually assumed to be good for stocks.

The circumstances surrounding changes in monetary policy are critical in assessing their impact on capital asset prices.

Rate Hike of December 16

The FOMC (Federal Open Market Committee) announced the hike in short-term interest rates at the conclusion of its two-day meeting of December 15-16.

The Committee indicated in a post-meeting statement that since its October meeting, "economic activity has been expanding at a moderate pace." The Committee noted that a number of economic data points had shown improvement, but inflation was still running below the Central Bank's stated 2% target.

The post-meeting statement further noted that the employment situation continues to improve and the Committee was "reasonably confident" that inflation will eventually work its way up to the 2% level over the "medium term."

Most of the language in the statement and the comments at the post-release press conference with FOMC Chair Janet Yellen were quite dovish, suggesting a gradual and multi-year set of interest rate increases. There certainly was no mention of abnormal upside economic growth, strains on capital or labor, or virulent and runaway inflation pressures.

So far, the news has created additional volatility in the capital markets.

Initial Rate Hikes and Impacts on Equity Prices

We reviewed the last six Fed tightening cycles, going back to 1983, and analyzed the performance of equities before and after each initial tightening.

As reflected in the table below, movement in the S&P 500 has been, on average, positive in the

three, six, and 12-month periods after an initial Fed rate hike. Negative returns have tended to be highest in the three-month period immediately after a rate increase, as was the case in 1994, 1999, and 2004.

Each Fed tightening cycle has a different set of prevailing conditions. For example, when the Fed tightened in June 1999, it said in a statement, "Economic activity in the United States has moved forward at a brisk pace." It also noted that labor markets had tightened.

In its statement following the June 2004 tightening, the Committee noted that "incoming inflation data are somewhat elevated," although they did attribute the increase to "transitory factors."

Tight labor markets and rising inflation are not currently the case, and they were not included in the Committee's statement last week.

S&P 500 Performance Before & After First Fed Tightening					
Date of First Raise	-6 Mos.	-3 Mos.	+3 Mos.	+6 Mos.	+12 Mos.
Mar-'83	27.0%	8.8%	9.9%	8.6%	4.1%
Jan-'87	0.2%	7.9%	19.1%	21.2%	2.6%
Mar-'88	-19.8%	4.1%	6.0%	5.4%	13.3%
Feb-'94	4.7%	2.7%	-3.9%	-2.4%	1.9%
Jun-'99	11.7%	6.7%	-6.6%	7.0%	6.0%
Jun-'04	2.6%	1.3%	-2.3%	6.2%	4.4%
Average	***4.4%***	***5.2%***	***3.7%***	***7.7%***	***5.4%***

Source: Strategas

Initial Rate Hikes and Equity Market Volatility

Investors are concerned not only about the direction of equity markets, but also about the risk in those prices. Another word for risk is volatility, or the degree to which equity prices fluctuate.

The table below tracks the same Fed tightening periods as the table above, but instead of performance, it reflects how volatile prices were in the months before and after each initial rate hike. The standard deviation is the degree (percentage) to which prices fluctuate around the arithmetic average or mean. Positive numbers indicate that the Index was more volatile, while negative numbers indicate an overall reduction in volatility.

S&P 500 Standard Deviation of 30 Day Daily Price Changes Before & After First Fed Tightening					
Date of First Raise	-6 Mos.	-3 Mos.	+3 Mos.	+6 Mos.	+12 Mos.
Mar-'83	-33.8%	-25.9%	-10.0%	-19.6%	-1.8%
Jan-'87	9.8%	-24.9%	-0.7%	-21.6%	98.2%
Mar-'88	-10.1%	-48.4%	15.3%	-19.5%	-14.4%
Feb-'94	13.3%	23.7%	37.0%	-9.5%	-33.4%
Jun-'99	-4.6%	-3.5%	0.1%	-35.7%	9.6%
Jun-'04	-8.8%	-27.9%	-7.0%	-6.7%	-20.1%
Dec-'15	40.5%	-48.2%			
Average ex Current	***-5.7%***	***-17.8%***	***5.8%***	***-18.8%***	***6.4%***

Source: Strategas

We have highlighted in the table above the volatility for the six- and three-month periods leading up to the December 2015 rate hike. It is interesting that volatility was a quite significant 40.5% in the middle of 2015, as there was a growing belief that the Fed was on the verge of increasing rates. However, volatility had dropped considerably to -48.2% in the three-month period immediately before the hike, as the market became more "comfortable" with the idea of an increase.

On average, it appears that volatility rises in the three months immediately after a first Fed rate hike and then declines six months later, before rising again one year after the initial action.

Conclusion

History serves as a guide, if an imperfect one. As the FOMC statement last week indicated, we see this tightening cycle as very gradual, with the Federal Reserve remaining accommodative. An important element in the equation is that the Central Bank plans to maintain its balance sheet holdings and stated that "it anticipates doing so

until normalization of the level of the federal funds rate is well under way."

In light of these events, we see the environment to be more favorable for high-quality and well-priced equity securities and funds, as compared to their fixed income counterparts, but we also expect the market to be more volatile.

Bryn Mawr Trust
Wealth Management Division
Harry R. Madeira, Jr. ("Gary") | Executive Vice President
610.581.4791 | gmadeira@bmtc.com
www.bmtcwealth.com