Infomail
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Need More Cowbell
(Baby, Don't Fear the Fed)

"In theory, there is no difference between theory and practice. In practice, there is" NY Yankee Great Yogi Berra

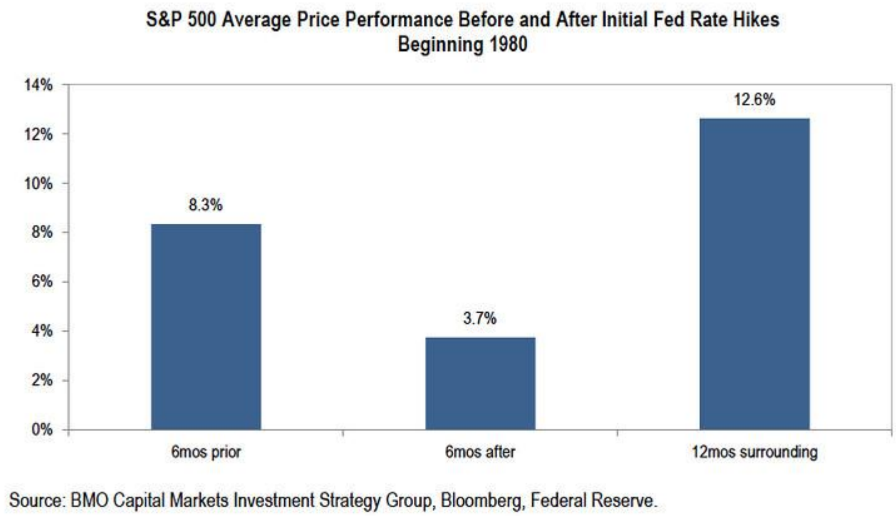
The recent 40th Anniversary Special for Saturday Night Live brought back some nostalgic memories and reminded me what a great time the 70's were to grow up. But with a tip to the Blue Oyster Cult hit, less I digress……

The talk these days is all about the Fed; when they will raise interest rates, by how much, how often, ad nauseum. So let's look at the facts, not the media created myths of rate-hike risk. It's been 9 years since the last fed hike so it's understandable there would be some nervousness. Let's look at recent cycles, and see what happens to the equity markets when the Federal Reserve begins to hike interest rates. For a long time we were warned that when the Fed announced the end of Quantitative Easing (QE) that it would create a huge spike in interest rates and a collapse in stocks. What really happened was exactly the opposite. Not any of it happened, but now the pundits want us to believe a rate hike is going to cause a steep decline, or perhaps even a crash.

The doomsday crowd has been wrong for over five years, and while economies are not booming, they are grinding along in the right direction. Sure there are always going to be issues to deal with in a globalized world, and sure we will still get 10-15% corrections, and the catalyst for it could be a Fed rate hike, but let's look at history and not hype.

In the months before the Fed begins raising rates, stocks begin a pullback, especially going into the first rate hikes as prior market gains get pared from the six months out to three months out. This has happened six months before every previous hike for the past five cycles:

Federal Reserve Rate Hike S&P Performance Before	6 Months	3 Months
1987	9.7	7.3
1994	4.7	2.7
1997	15.1	5.1
1999	11.4	5.5
2004	2.8	1.2
Average	8.7	4.4



With respect to Price Earnings history when interest rates go up, here's how that fares (and it's important to note that the S&P is nowhere near recent valuation levels seen in past cycles):

Federal Reserve Rate Hike S&P Performance After	3 Months	6 Months
1987	-29.3	-15
1994	-3.9	-2.4
1997	12.7	18.9
1999	-6.6	6.7
2004	-2.3	6.4
Average	-5.9	-2.9

Finally, here's what Price Earnings levels were at when interest rate hikes began:

Federal Reserve Rate Hike	PE Ratio
1987	20.0
1994	21.5
1997	19.6
1999	33.5
2004	20.3
Average	23.0

Today, the S&P 500 P/E sits at 15-16X earnings.

The interesting part is this: The S&P 500 has an average gain of almost +5% six months after the first rate hike (going back to WWII) and in the last three cycles (1997, 1999, 2004) an average increase of +10.66% (18.9%, 6.7%, 6.4%) six months after the first increase:

S&P 500 Valuations and Returns Three and Six Months Before and After the First Rate Hike Since 1946

Rate Hike Periods		Rate Level*		S&P 500 GAAP P/E Ratios					S&P 500 Price % Changes			
				Before		Date of	After		Before		After	
Start	End	Start	End	6 Mos.	3 Mos.	Hike	3 Mos.	6 Mos.	6 Mos.	3 Mos.	3 Mos.	6 Mos.
04/25/46	01/16/53	0.50	2.00	16.6	18.8	20.6	20.8	16.5	13.0	2.5	(5.6)	(20.7)
04/15/55	08/23/57	1.50	3.50	12.1	12.7	12.8	13.2	12.0	19.7	7.6	11.7	8.6
09/12/58	09/11/59	1.75	4.00	13.5	15.3	16.9	18.4	18.2	14.4	8.4	9.7	16.6
07/17/63	12/06/65	3.00	4.50	17.7	18.6	18.0	17.4	18.2	5.8	0.0	6.3	11.1
11/20/67	04/19/68	4.00	5.50	16.9	17.8	17.3	17.2	16.7	(0.5)	(3.3)	(0.9)	5.2
12/18/68	04/04/69	5.25	6.00	18.0	17.9	18.5	18.3	16.9	6.7	5.1	(7.7)	(8.3)
07/16/71	07/16/71	4.75	5.00	18.1	19.8	18.6	18.3	17.2	6.5	(4.2)	(1.3)	4.3
01/15/73	04/25/74	4.50	8.00	17.9	17.6	18.4	17.4	15.5	10.9	9.7	(5.4)	(12.1)
08/30/77	02/15/80	5.25	13.00	10.1	9.6	9.2	9.0	8.7	(3.4)	0.1	(1.6)	(9.7)
09/26/80	05/05/81	10.00	14.00	6.5	7.8	8.6	8.5	9.4	28.0	8.7	8.1	7.9
04/09/84	04/09/84	8.50	9.00	12.8	12.0	10.2	9.6	9.3	(9.0)	(8.0)	(1.3)	4.0
09/04/87	02/24/89	5.50	7.00	19.1	20.5	20.0	18.1	12.0	9.7	7.3	(29.3)	(15.0)
02/04/94	02/01/95	3.00	6.00	23.2	22.4	21.5	20.7	17.9	4.7	2.7	(3.9)	(2.4)
03/25/97	03/25/97	5.25	5.50	19.1	19.4	19.6	19.5	21.9	15.1	5.1	12.7	18.9
06/30/99	05/16/00	4.75	6.50	32.7	33.9	33.5	31.2	26.6	11.4	5.5	(6.6)	6.7
06/30/04	06/29/06	1.00	5.25	22.7	21.6	20.3	19.8	19.1	2.8	1.2	(2.3)	6.4
Medians:		**4.63**	**5.75**	**17.8**	**18.3**	**18.5**	**18.2**	**16.8**	**8.2**	**3.9**	**(1.5)**	**4.8**

Source: S&P Capital IQ, Federal Reserve. *Discount Rates were used prior to 1989, while Fed funds were used thereafter. Past performance is no guarantee of future results. **P/E Expansion** **P/E Contraction**

What is interesting at this time which is different from other cycles I've witnessed is that while it seems the rest of the world is still stimulating via lower rates (this week China and India, recently Canada, the EU, Australia among others) the USA seems alone in its intent. The problem is, they probably should have raised rates modestly some time ago (maybe even as early as 2012) so now they seem to be almost fearful of raising and what the implications and market reaction will be.

The US dollar has skyrocketed as of late, and on Friday the Euro broke 1.10 USD, a level not seen since 2003. The high US dollar is already biting into US corporate profits, as recent multinational earnings have been hurt by the high dollar.

I believe rates may stay lower for longer than most may think. While the global economy is in recovery, it remains fragile and that "race to the bottom" most countries are aiming for with their currencies keeps in motion. The Fed will err on the side of caution and move slowly.

The fact is, the US economy will never reach its full potential under this administration. Maybe the Fed knows that. But as the politics ratchet up in the next 6-8 months for the Presidential campaign, the markets will start getting a sniff that a change is coming.

Until then, we will simply need more Cowbell (stimulus) to keep the economic song on track.

Stay tuned,

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