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I. D. E. A.

IMPACT OF FED POLICY SHIFTS ON THE STOCK MARKET

Global equity markets have been crashing for more than a week, and there appears to be an intertwined feedback dragging down global debt markets. Most analysts are attributing the crash in key asset markets to the fact that the Fed ended more than 16 months of unchanged monetary policy with their Fed funds hike on February 4th, which also signaled the end of nearly 4 years of accommodative monetary policy. Can a change in Fed policy really have such an impact on global asset markets? We have previously answered this question in the affirmative for the bond market (see our *I.D.E.A. Letter* dated February 7, 1994), and have chosen to undertake a similar examination for equity markets.

We examined equity market movements following major Fed policy shifts from ease to tighten. We have identified 7 major shifts since 1947, and they are briefly described in the accompanying table. Arguably there have been more than 7 occasions when the Fed has shifted from an easing stance to a tightening stance in the last 47 years, particularly if one chooses to examine shifts in the Fed funds rate as well as the discount rate. However, after examining all such shifts we decided that only these 7 were valid, insofar as the others appear to have been "mistakes" on the part of the Fed - i.e., brief tightenings that were quickly reversed by the Fed in order to return to an established easing trend. Also, the lack of consistency in the Fed's procedural handling of the Fed funds rate, not to mention the lack of a meaningful Fed funds market prior to 1964, argues that the discount rate should be the sole measure of Fed policy when doing a long-term analysis. Along with the tabular presentation of these 7 occurrences we have also included a graph of the equity market reaction following the latest 4 such shifts.

It appears that if one is willing to have a one-year window of examination following these 7 moves, some bearish equity market reaction can be seen in all 7 occurrences. In some cases the reaction was mild and only lasted a few months, in others the Fed tightening simply extended a then-current bear cycle a few more months, and in one instance the Fed tightening appears to have triggered a two-year slide that ate away more than 40% of the equity market's value. More familiar to today's traders would be the Fed hike in September 1987, which preceded the now-infamous Crash of 87 by just a little more than a month.

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ECONOMIC EXPLANATION: As we have argued in our previous letter, a switch from easing to tightening by the Fed tells the markets something they did not know before - that the Fed is sufficiently concerned about inflation to do something about it. Additionally, if Fed easings do cause or contribute to inflation, there is no time of greater risk that the seeds of future inflation have been sown than the time when the Fed is pulling back from a previous easing mode. Remember: an initial Fed tightening is not a sign of a tight Fed policy, it is a deceleration of an accommodative policy. Not until the Fed passes through a neutral policy level can a tightening be said to be contributing to a tight monetary policy. Thus, in the months just following a switch from ease to tightening, market players are justifiably concerned that a central bank that has just admitted they are worried about inflation has not done enough to slow down their own contribution to that future inflation. This perception is not only negative for debt markets it is also negative for equity markets - expectational inertia amongst stock analysts argues against an immediate and widespread raising of earnings projections following a pickup in inflation fears, while risk averse bond traders quickly push bond yields (and thus the cost of capital that stock analysts use to discount future earnings flows) sharply higher with their inflation nervousness. The outpacing of the rise in the inflationary expectations component of interest rates over earnings growth estimates lowers the present value of stocks, pulling the equity markets down.

TRADING RECOMMENDATION: The fact that equity market reactions to Fed policy switches have ranged from mild to disastrous is likely the result of how quickly the bond markets (which establish the discounting factors for stock analysts) tend to view the Fed's policy switch as sufficiently aggressive to choke off whatever inflation they have come to dread. Since the current Fed appears to be dallying in their return to a neutral policy (for political reasons as well as for their unique concern for bank and corporate balance sheet restructurings this time around), we would not look for the markets to develop a perception that the Fed is being aggressive against inflation any time soon. Thus we would expect a continued correction in global equity markets, which should continue to weigh on bonds. We would be willing to take the position that the yield on the long bond is not likely to return below 7.00% for the remainder of this stage of the interest rate cycle, which surely includes the remainder of 1994. Portfolio managers would be advised not to chase after seemingly attractive yields out the curve until at least another 50-75 bps has been discounted.

THE HISTORICAL IMPACT OF FED RATE HIKES ON U.S. EQUITY MARKETS

Date of First Tightening in Rate Cycle	Time Since Last Fed Tightening	Description Of Equity Market Movement around the First Tightening	S&P 500 6 Mths Later	S&P 500 12 Mths Later
Sep 4 1987	41 months	A strong, year-long rally ended one month after the first Fed tightening in a single huge crash. Further bearish equity market moves for the next 3 months, then sideways trading for a few more months, then a new bull equity market.	-18%	-16%
Sep 26 1980	7 months	A bear market in equities that had turned bullish only 4 months before the first Fed tightening strengthened for two more months and then entered a 2-year bear market.	+9%	-4%
Aug 30 1977	41 months	A bear market in equities that had been in place a little under a year before the first Fed tightening was extended another 7 or 8 months following the tightening.	-10%	+3%
Jan 15 1973	18 months	A modestly strong equity market started to crash almost immediately following the first Fed tightening, and continued downward for about two years. The equity market lost more than 40% of its value from its peak in Jan 1973 to its trough in Dec 74.	-16%	-16%
Jul 17 1963	47 months	A very strong equity market slowed for two months following the first Fed tightening, then returned to full strength for the remainder of most of the decade.	+8%	+20%
Sep 12 1958	13 months	An extremely strong equity market didn't even begin to slow down for almost 6 months after the first Fed tightening, but then turned very bearish about a year later.	+17%	+17%
Apr 15 1955	27 months	An extremely strong equity market slowed the month after the first Fed tightening, but then resumed its bullish run for at least a year following.	+2%	+14%

NOTES:

1. The "Date of First Tightening" refers to the effective date of the first discount rate hike that ended a clear-cut easing cycle and began a clear-cut tightening cycle.
2. The "Time Since Last Tightening" refers to the number of months prior to the announcement date of the discount rate hike that the Fed had last hiked the discount rate.
3. Percentage moves listed for the S&P 500 over 6 and 12 month horizons are not annualized.

U.S. Stock Market Movements in the 24 Months Following Initial Fed Tightenings