Wells Capital Management

Economic and Market Perspective

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The Main Event

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In recent months, the U.S. stock market has been dealing with several potential risks including Russian aggressions, Iranian negotiations, Puerto Rican bad debts, a Chinese stock market collapse, and a never-ending Greek drama. However, these have only been sideshows or warm-up acts for the main event of year—Fed tightening!

For the first time in this recovery, the Fed will likely begin raising interest rates yet this year either in September or December. Currently the stock market does not seem too worried. After all, equities just faced a litany of various global risks and came through mostly unscathed. Moreover, the excessively communicative Fed has worked hard so as not to surprise anyone by this policy change and chairman Yellen has again and again assured that tightening moves will only be gradual, methodical, and well orchestrated (i.e., she seems to suggest most of us will hardly notice interest rates have risen). Indeed, with short-term rates currently near zero, why should a slow and modest rise in the federal funds interest rate be unsettling for the financial markets?

Perhaps the main event will prove a non-event. However, our guess is the first Fed tightening of this unprecedented monetary easing cycle may produce more turbulence in the stock market than currently anticipated. In the post-war era, the stock market has often struggled in the year following the first Fed rate hike. Moreover, because the Fed has waited so long to initiate tightening, the stock market currently exhibits several vulnerabilities which may make it more sensitive to Fed actions compared to past recoveries.

Stock market and first Fed hikes

Chart 1 illustrates the first monetary tightening of each economic recovery since 1950 and Chart 2 shows how the U.S. stock market performed in the year immediately following the first interest-rate hike. In nine previous recoveries, the stock market has risen on average by about 5% in the year following the initial interest-rate hike. However, this positive average is mainly due to two large gains after rate hikes in the 1950s. Since the 1960s, the stock market has fallen by about 1% on average in the following year. Moreover, the stock market suffered declines in the coming year in four of the seven cycles and offered investors a return of less than 5% in six of the last seven tightening cycles.

Perhaps the stock market will continue providing investors solid returns despite the Fed initiating rate hikes. However, at least for the last 55 years, history suggests some caution is warranted.

Chart 1

Federal funds interest rate*

*Three-month T-bill yield until July 1954 and federal funds rate thereafter.

Black dots represent the month of the first Federal Reserve interest-rate hike for each recovery since 1950.

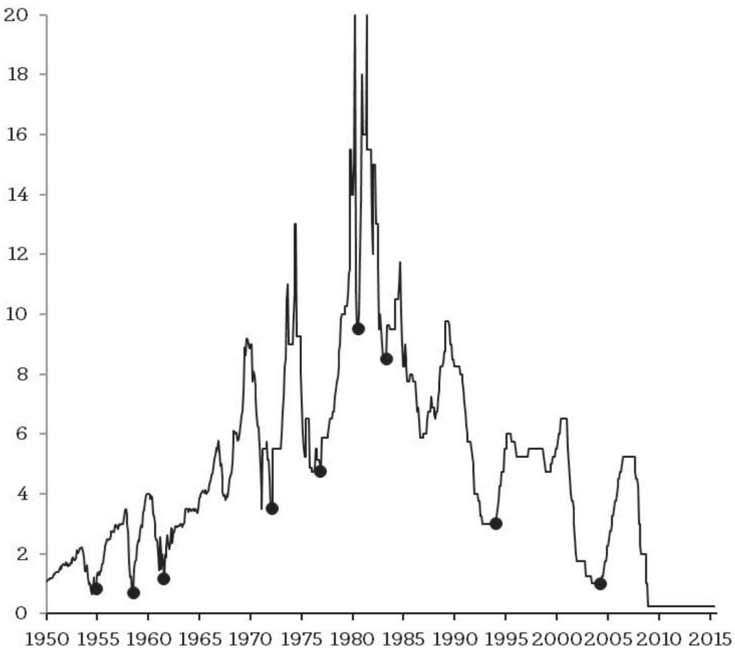
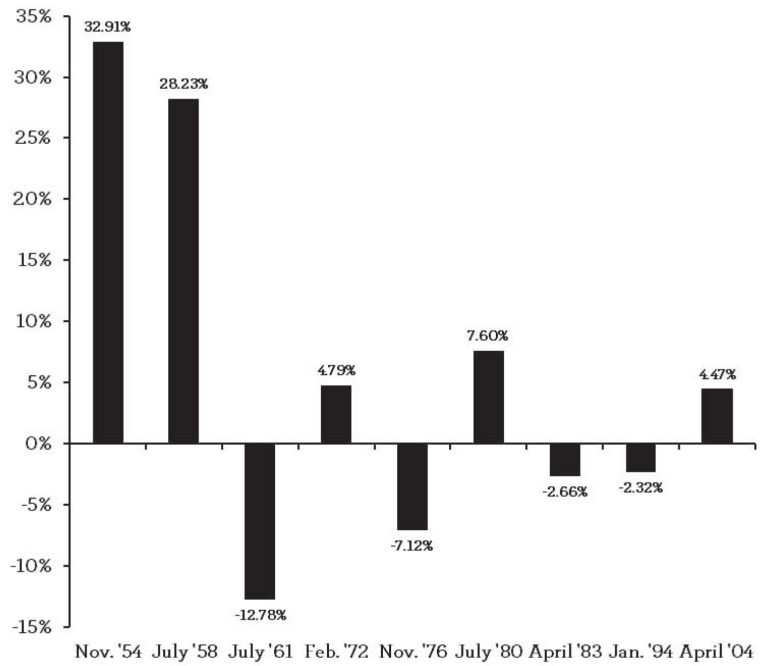


Chart 2

S&P 500 Stock Price Index

Percent change one year after first Federal Reserve interest-rate hike



Isn't this tightening cycle most comparable to the 1950's?

As shown in Chart 1, the Fed will initially lift short-term interest rates from a post-war low near zero. The comparable period may be the 1950s when interest rates were also very low. Like the 1950s, since interest rates are so low today, could the stock market simply plow ahead as it did then despite the Fed beginning the process of raising interest rates?

Interest rates were nearly as low in the early 1960s when the Fed first raised interest rates and the stock market subsequently declined by almost 13% in the next year. Similarly, in 2004, the funds rate was also quite low and once the Fed began to raise interest rates the stock market trended sideways for most of the next year rising by only about 4.5%.

In our view, it is not the level of interest rates which matters most when the Fed first begins to hike as it is the environment surrounding the tightening cycle. Compared to any recovery since, the environment surrounding the stock market in the 1950s (e.g., its valuation level, investor sentiment, and the maturity of the earnings cycle) was far more hospitable. As the early 1960s and 2004 examples suggest, despite Fed tightening, the 1950s stock market did well primarily because, in comparison, the environment for stocks was far more favorable.

Stock market vulnerabilities are notable as Fed tightening nears

Several aspects surrounding today's stock market make it appear abnormally vulnerable as the Fed begins the process of finally raising interest rates. First, the current price/earnings (P/E) multiple is among the highest of any Fed initiation cycle. Second, investor sentiment is probably a bit too calm since the stock market has not experienced a correction for more than 900 trading days, the third longest in post-war history. Third, the Fed begins this tightening cycle from the lowest unemployment rate of any post-war recovery. Finally, tightening begins when corporate profit margins are near historic highs and while earnings growth is already well past its best growth rates of the recovery.

Perhaps the stock market will be little affected by the Fed finally lifting interest rates from zero. However, these notable vulnerabilities suggest at least some period of stock market turbulence as the Fed begins to normalize monetary policy.

Stock market valuation is extended

Currently, the stock market P/E multiple (Chart 3) is about 19 times earnings. Five historic tightening cycles were initiated at significantly lower stock market valuations. For example, in both economic recoveries during the 1950s, the Fed began raising interest rates when the P/E multiple was still below 15.

In both the 1960s and early 1970s, the Fed began lifting interest rates when the P/E multiple was slightly higher than it is today and both times the stock market eventually suffered a significant correction. In the mid-1990s, the P/E multiple was significantly higher than it is today and the stock market only declined mildly in the next year. Similarly, in the mid-2000s, the P/E multiple was about equal to where it is today and the stock market was flat to up slightly in the coming year. However, in both of these instances, unlike today, earnings were rising strongly and would increase significantly more after the Fed began tightening (this can be seen by examining Chart 7 below). Indeed, the P/E multiple declined in both the 1990s and 2000s because earning were rising faster than the stock market. By contrast, today, the P/E multiple is also high but has been rising for the last several years since earnings have been growing more slowly than the stock market.

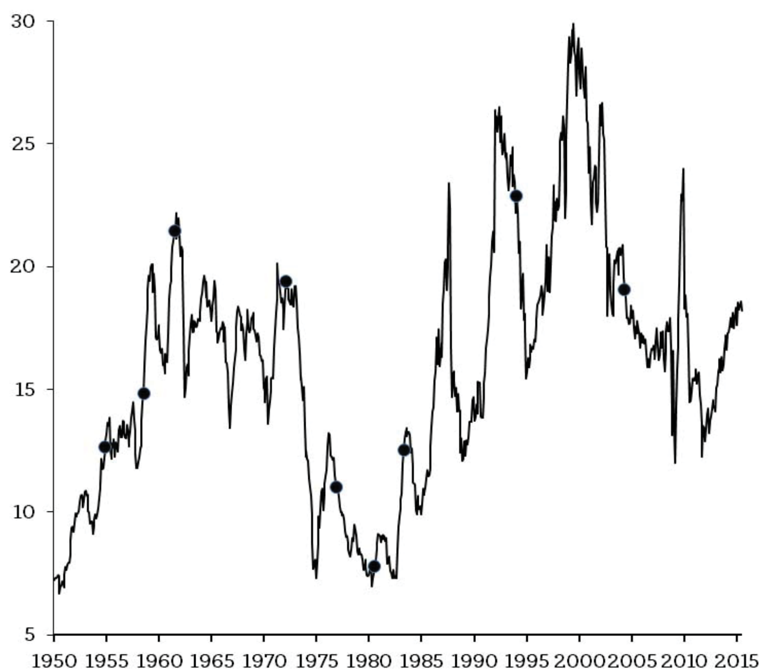
In our view, compared to post-war history, the Fed is about to raise interest rates soon in a stock market with a fairly extended valuation profile.

Chart 3

S&P 500 P/E mulitple

Price to trailing 12-month earings per share

Black dots represent the month of the first Federal Reserve interest-rate hike for each recovery since 1950.



Investor sentiment appears vulnerable

The stock market is probably less sensitive to interest-rate hikes when investor sentiment is bearish. That is, if most investors are hunkered down and already prepared for the worst, higher interest rates are often incorporated in market prices before the Fed starts the process.

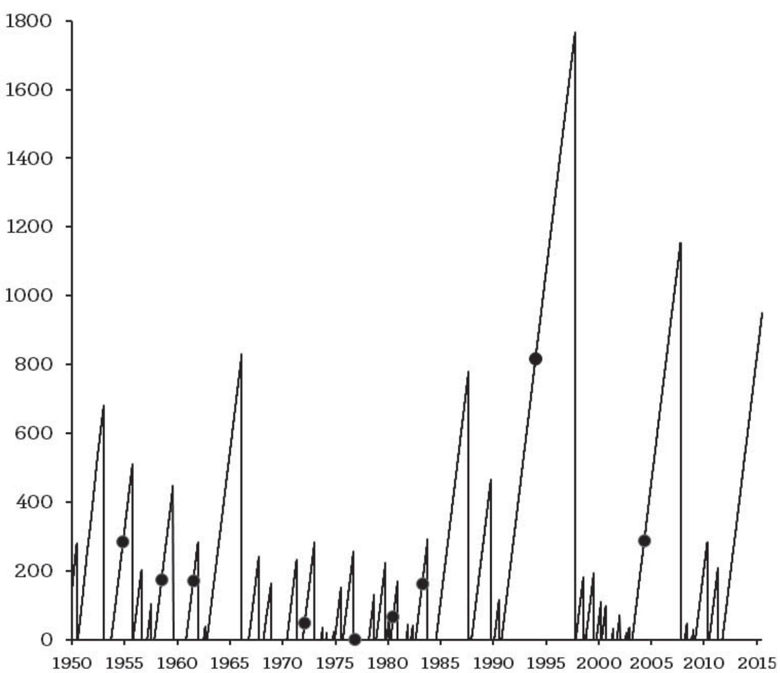
Certainly bearishness is not rampant today as it was earlier in this recovery. However, as suggested by Chart 4, investors may be rather sanguine about the future since it has been so long since the stock market has suffered a correction. This chart illustrates the number of trading days since a correction and currently the S&P 500 Index has gone more than 900 trading days without a refreshing pause (i.e., importantly a pause which adjusts or improves investor sentiment). As shown, the Fed will begin the contemporary tightening cycle after the third longest period without a stock market correction and the longest stretch before an initial Fed tightening in the post-war era. Indeed, outside of the 1990s, the Fed has initially tightened when investors experienced a correction within the last year (i.e., at or below about 200 trading days without a correction). Consequently, if financial market turbulence does result from Fed actions, it could catch many investors off guard, perhaps resulting in a stock market decline deeper than most now anticipate.

Chart 4

Number of trading days since last correction

S&P 500 Composite Stock Price Index

Black dots represent the month of the first Federal Reserve interest-rate hike for each recovery since 1950.



A tight labor market

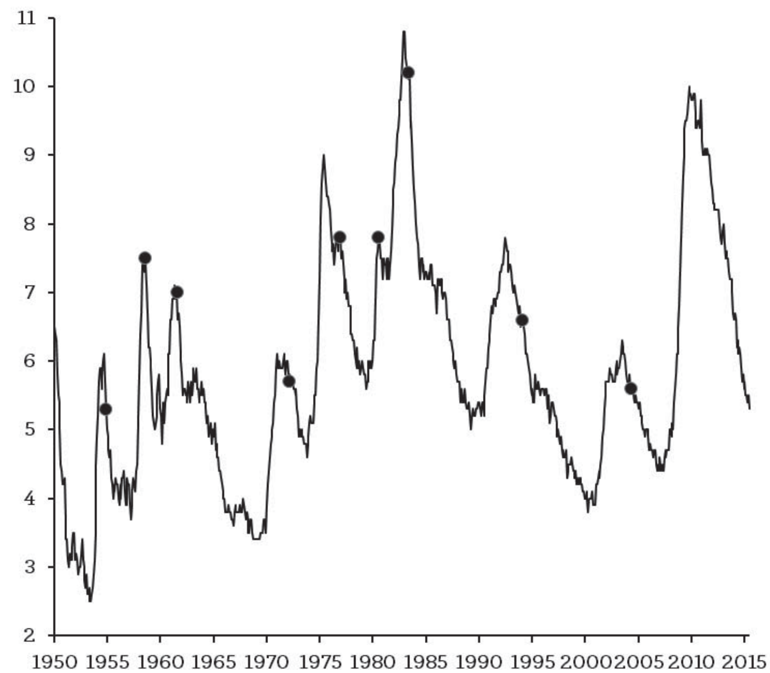
When the Fed does finally tighten later this year, the unemployment rate is likely to be the lowest at the start of any Fed tightening cycle in post-war history (Chart 5). This suggests the Fed may indeed be behind the curve. At a minimum, since the Fed has waited so long to begin the process and the labor market has already returned close to full employment, it would not be surprising if this tightening cycle quickly develops outsided cost-push profit margin pressures.

The Fed has long maintained that tightening will be slow, methodical, and well controlled. However, starting the process with the labor market already closer to full employment compared to any other recovery cycle in post-war history does not build confidence the Fed will be able to honor this promise.

Chart 5

U.S. labor unemployment rate

Black dots represent the month of the first Federal Reserve interest-rate hike for each recovery since 1950.



The earnings cycle is already old

Charts 6 and 7 show that corporate earnings performance is already far past its best for this cycle. Traditionally, the Fed has started tightening much sooner in the recovery when earnings were still recovering sharply from the previous recession. That is, often higher interest rates are buffered by strong earnings trends. Today, however, since the Fed has waited so long to initiate the process, the earnings cycle has already aged reducing the buffer against the bite of higher interest rates facing the stock market.

As shown in Chart 6, profit margins have never been as high as they are today when the Fed first began to tighten interest rates. Moreover, in every previous instance in post-war history, profit margins were still rising and had not yet reached cycle peaks when the Fed first began to lift rates. By contrast, today, profit margins most likely already peaked. They are not likely to rise much since they are near post-war highs and the labor market has already returned close to full employment. Neither the Fed nor investors should expect a buffer from profit margins as they begin to raise interest rates.

Chart 7 shows that the contemporary earnings cycle is already quite mature. Normally, S&P 500 trailing earnings per share have yet to surpass their previous recovery highs as the Fed begins to tighten. Traditionally, the earnings cycle provides the Fed with an exit ramp to tighten monetary policy.

By contrast, earnings growth in this recovery peaked several years ago and with profit margins already near record highs and perhaps rolling over, earnings at best are likely to grow much slower during the balance of this recovery. The Fed has simply waited too long to begin tightening in this recovery and consequently, the matured earnings cycle no longer represents its traditional buffer for the stock market nor an exit ramp for Fed policy.

Chart 6

U.S. corporate profit margins*

*Total U.S. corporate profits as a percent of nominal GDP
Black dots represent the month of the first Federal Reserve interest-rate hike for each recovery since 1950.

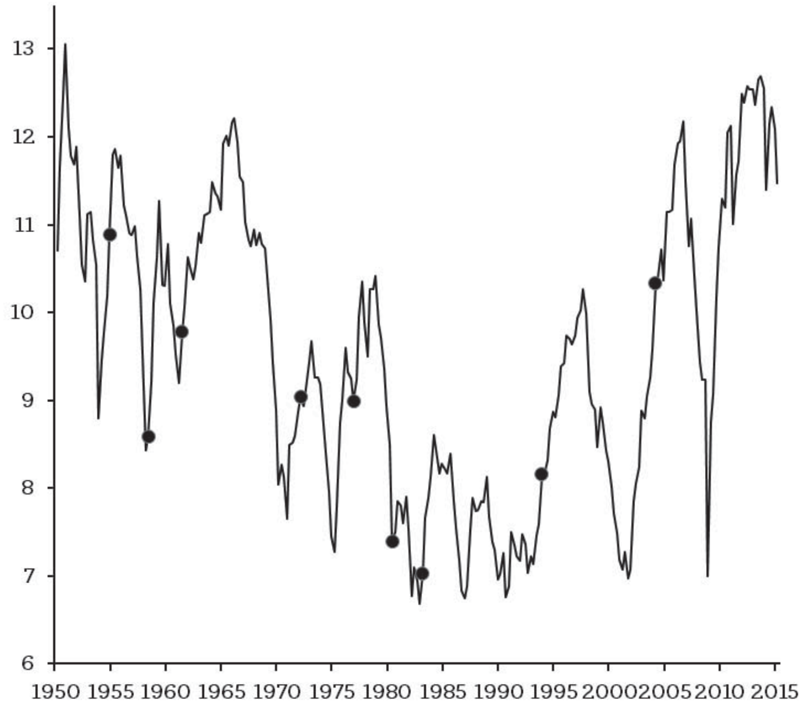
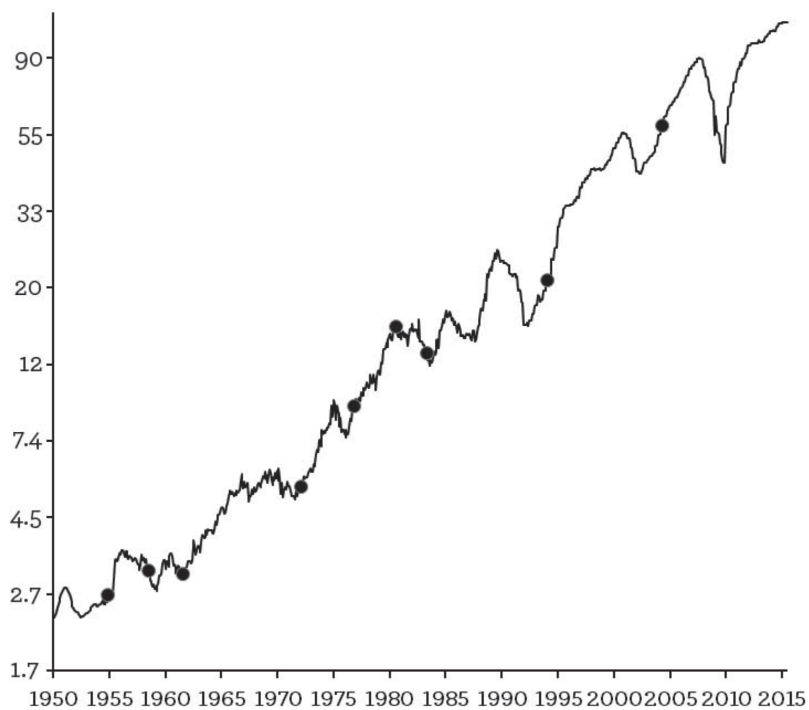


Chart 7

S&P 500 trailing 12-month earnings per share

Natural log scale
Black dots represent the month of the first Federal Reserve interest-rate hike for each recovery since 1950.



Summary

The Fed will soon begin to finally raise interest rates for the first time in this recovery. Perhaps, as the Fed regularly advertises and as many investors anticipate, the "main event" will pass with little fanfare or consequence for the financial markets. However, we suggest caution and suspect additional stock market turbulence and maybe a correction is yet forthcoming.

The stock market has usually suffered at least a period of flatness in the year following an initial Fed tightening. Moreover, the environment surrounding the stock market in this recovery appears much more vulnerable compared to past recoveries when the Fed was nearing its first tightening move.

Valuations in the current stock market are more extended, the stock market has not experienced much turbulence in recent years, the economy has already returned to near full employment, and the earnings cycle (both profit margins and earnings growth) is much more mature and far past its best performance.

We are in the "mother" of all U.S. monetary easing cycles. The financial markets have been supported throughout this recovery by a massive and unconventional monetary policy. It seems a bit unrealistic to expect the stock market to simply skate right through as the Fed finally attempts to turn the monetary boat for the first time in this unprecedented monetary cycle. Perhaps, the stock market will surprise and continue to zoom ahead even as the Fed finally begins to normalize policy. However, the stock market has trended mainly sideways ever since the Fed stopped adding to quantitative easing last year. And, it does not seem unreasonable for the stock market to struggle even more, at least for a time, with the first rise in short-term interest rates in almost a decade.

Thanks for taking a Look!!

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An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.

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