

TACTICAL INVESTMENT INSIGHTS

WHAT HAPPENED TO STOCKS WHEN THE FED WAS TIGHTENING

Henry Ma, Ph.D., CFA
President and Chief Investment Officer



The stock market plunged on rising interest rates worries after stronger-than-expected job and wage numbers were reported on February 2nd. The sharp sell-off in the following trading sessions sent the S&P 500 Index down by 8.5% in five days. Investors were concerned that the Federal Reserve may increase interest rates more aggressively as inflation may pick up.

Normally, higher interest rates will result in higher borrowing costs for both consumers and businesses. This means households will have less discretionary income to spend and companies are unwilling to borrow to expand. Higher interest rates also mean equity investments are less attractive because investors can get higher returns elsewhere. Holding everything else constant, higher interest rates are unfavorable for stocks. However, historically, during the Fed tightening cycles, the stock market did not perform poorly.

Table 1 shows the S&P 500 Index performance during the last eight Fed tightening cycles since 1970. The stock market generated positive returns in every cycle. On average, it returned about 6% annually. The levels of rate hikes varied from 1.8% to 12.9%, but the stock market performance does not seem to have a strong correlation with the magnitudes of the rate increases.

Another interesting observation is that the price/earnings ratios contracted in seven of the eight tightening cycles. That means companies had experienced solid earnings growth during those periods. It was evident that the negative effect of rising interest rates was offset by the positive effect of earnings growth. As a result, the stock market rose in every tightening cycle.

According to FactSet, as of February 9th, for Q4 2017, with 68% of the companies in the S&P 500 reporting earnings, 74% of the companies have beaten estimates. The blended earnings growth rate is 14.0%. All eleven sectors have positive earnings growth. The strong fundamentals and corporate earnings growth could have contributed to the quick market recovery this week. As of today (Feb. 16th), the stock market has recouped most of the losses from last week.

Taken as an individual factor, rising interest rates is a negative for stocks, but it is one of the many factors determining stock market performance. Economic fundamentals and corporate earnings play important roles as well.

Table 1: Stock Market Performance During Fed Tightening Cycles

Tightening Cycle (Beginning Month - End Month)	S&P Index Price Level	S&P PE Ratio	Federal Funds Effective Rate (%)	Change of S&P 500 Index	Change of PE ratio	Change of Federal Funds rates (%)
2/29/1972 - 9/28/1973	106.6 108.4	19.4 14.6	3.3 10.8	1.7%	-4.8	7.5
4/29/1977- 4/30/1980	98.4 106.3	10.0 7.0	4.7 17.6	8.0%	-3.1	12.9
7/31/1980- 7/31/1981	121.7 130.9	7.8 8.8	9.0 19.0	7.6%	1.0	10.0
2/28/1983- 8/31/1984	148.1 166.7	10.7 10.7	8.5 11.6	12.6%	-0.1	3.1
11/28/1986- 3/31/1989	249.2 294.9	16.9 12.3	6.0 9.9	18.3%	-4.6	3.8
1/31/1994- 2/28/1995	481.6 487.4	22.8 16.2	3.1 5.9	1.2%	-6.6	2.9
6/30/1999- 6/30/2000	1372.7 1454.6	29.8 27.3	4.8 6.5	6.0%	-2.5	1.8
6/30/2004- 7/31/2006	1140.8 1276.7	18.8 16.0	1.0 5.2	11.9%	-2.8	4.2

Sources: Bloomberg, FactSet, Fed Reserve St. Louis, Julex Capital

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40 Grove Street, Suite 140

Wellesley, MA 02482

781-489-5279

Henry.ma@julexcapital.com

www.julexcapital.com

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