TrendMacrolytics

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The Right Tight

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Tightening cycles can be good for stocks -- if the Fed gets it right for a change.

Be careful what you wish for. Our long-expected "buyable dip" has not only come, it's taken on the stench of panic (we'd rather have been wrong). To the extent that fear of **the Fed** raising interest rates is the motivating factor, then the panic makes the dip all the more buyable. If you want something to worry about, worry that the Fed *won't* raise rates -- or won't raise them fast enough.

Yes, the conventional wisdom is that stocks love it when the Fed eases, and hate it when the Fed tightens. But the truth is that stocks love it when the Fed acts decisively and appropriately, and hate it when the Fed acts ambiguously and incorrectly. For stocks, the right tightening is better than the wrong easing.

It's true that since the top in the fed funds rate in 1981, the average daily return for the S&P 500 was higher during the five easing cycles (13.2% annualized, excluding dividends) than during the four tightening cycles (7.4% annualized). But that fact does not establish a cause-and-effect relationship between fed policy and stock returns. Recent performance flatly contradicts such a relationship -- the S&P 500 is down 14.5% from January 3, 2001, when the current easing cycle began (so much for "don't fight the Fed"). Focusing on the periods directly proximate to the onset of the last five tightening and four easing cycles shows similarly contradictory results.

S&P 500 returns				
	Before cycle onset		After cycle onset	
	3 months	3 months	6 months	12 months
Easing cycles	4.83%	-4.10%	1.19%	-1.08%
Tightening cycles	7.00%	1.00%	6.06%	1.28%
All periods	2.20%	2.20%	4.45%	8.87%

- On average, the stock market performed better over the three and six months following the onset of the *tightening* cycles than it did following the onset of easing cycles, and better than the average of *all* three-month and six-month periods over the same years.
- Those results are *not* because the market anticipated upcoming rate cycles and discounted for them. On average the stock market performed better over the three months *before* the onset of the tightening cycles, too.

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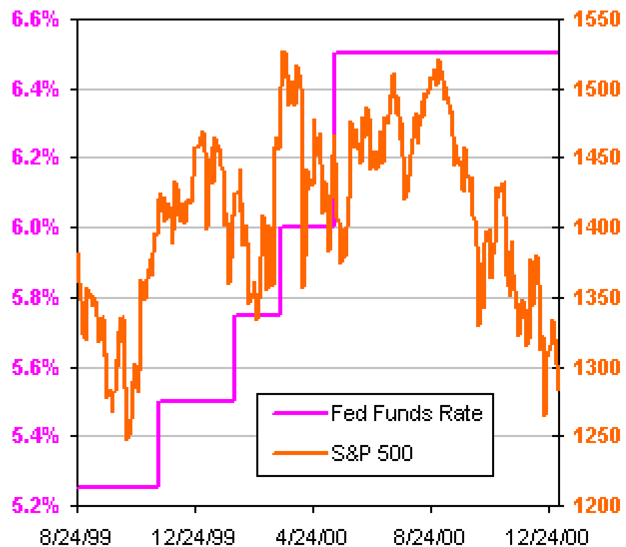
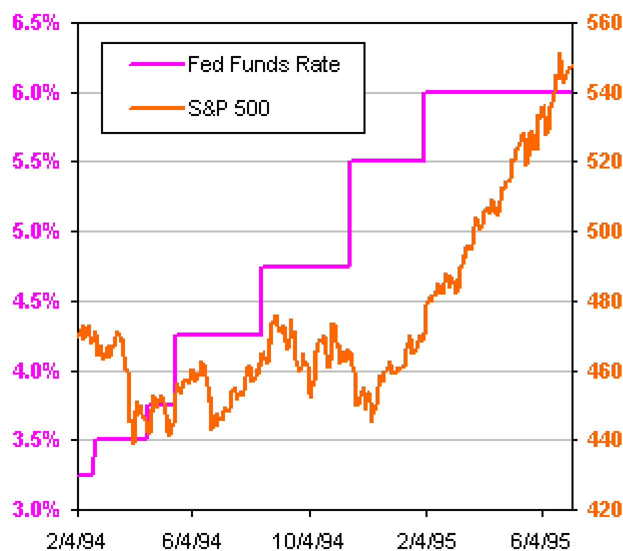
- Looking out further than six months from the onset of new Fed cycles, on average the stock market has performed better over the twelve months following the onset of *tightening* cycles, than it has following the onset of easing cycles. However, *both* are well below the average performance for *all* twelve-month periods. If this suggests anything at all about Fed cycles, it would be that *anything* the Fed does is worse that doing nothing.

Let's look one-by-one at the last three tightening cycles. The most recent, from June 1999 to January 2001, saw the S&P 500 fall by 5.04% (excluding dividends). But this was not a typical tightening cycle, and conditions at its onset were unlike today in almost every way. After 100 months, the economic expansion was more than mature. The stock market was riding for a fall, near all-time peak valuations relative to expected earnings and interest rates. **Alan Greenspan** made no secret of his intention to use rising interest rates to rein in "irrational exuberance" and "asset inflation."

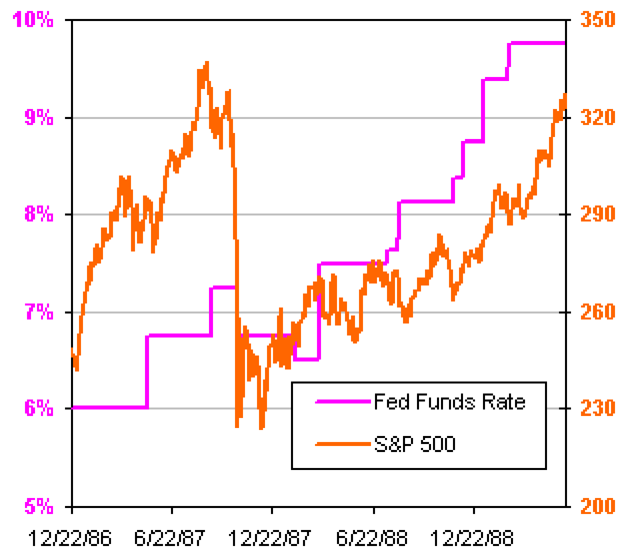


The tightening cycle before that began in February 1994 and ran through July 1995, with the S&P 500 rising 13.8% (excluding dividends), with most of the gains coming at the end of the cycle when rates were at their highest. As deep and as long as the current easing cycle seems (and as shocking as the prospect of tightening cycle may therefore feel), the easing cycle that preceded the 1994-95 tightening cycle was even deeper and longer. The easing cycle from June 1989 to February 1994 saw the fed funds rate drop 6.75%, from 9.75% to 3% over 1701 days, with the 3% rate held for 577 days (now *that's* a "considerable period"). By contrast, the current easing cycle has seen the fed funds rate fall 5.5%, from 6.5% to 1% over 1225 days, with the current 1% rate held for 322 days. When the first rate hike came in February 1994, the S&P 500 was slightly undervalued in terms of then-prevailing expected earnings and interest rates. Today the S&P 500 is somewhat more undervalued.

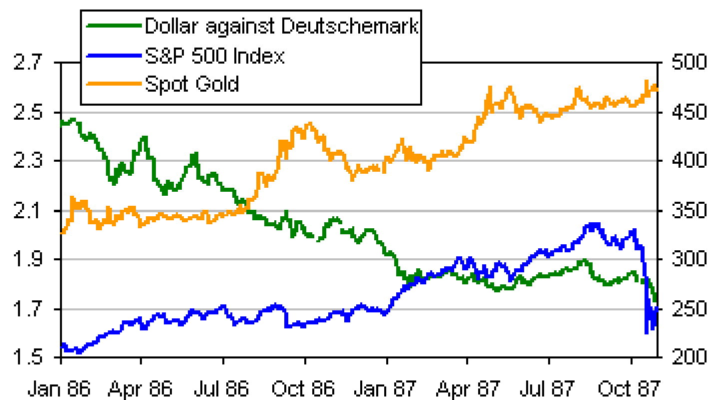


While most commentators have focused on the 1994 tightening cycle as the one most analogous to the one facing us now, the cycle that ran from December 1986 to June 1989 is in some respects a closer match. Over that cycle the S&P 500 gained 30.9% (excluding dividends). At the cycle's onset, the economic expansion was more mature than it is today, at 49 months. But the liquidity environment was very much like today's, following a long period of surging gold, commodity and forex prices that signaled mounting inflationary pressures. When the first rate hike came, the S&P 500 was somewhat more undervalued in terms of then-prevailing expected earnings and interest rates than it is today.

Over the first nine months of the cycle, the fed funds rate was hiked from 5.88% to 7.25%. Bonds crashed, with 10-year Treasury yields rising from 7% to over 10% (today's blood-letting in bonds may be just beginning). Yet it would seem that in the face of inflation risk, tightening was a very stock-friendly thing for the Fed to do. Stocks soared from the moment of the first rate hike, with the S&P 500 gaining as much as 34.5% (excluding dividends) over eight months. The crash of October 19, 1987, was the dramatic culmination of a decline that had begun shortly before the third rate hike in the ninth month.



Was the crash a case of the old "three steps and a stumble" rule? Hardly. Stocks celebrated the first two rate hikes in that tightening cycle, seeing them as an appropriate response to the inflation warnings coming from gold, commodities and the dollar. Inflationary acceleration became undeniable with the core Consumer Price Index bottoming in February 1987, and turning upwards. But by late summer, it was becoming increasing clear that the Fed wasn't doing enough. Gold had continued to climb and the dollar had continued to fall. On Thursday, October 15, the dollar hit the floor against the Deutschemark that had been established under the Louvre accord in February, and on Sunday, October 18, the ***New York Times*** reported that **Treasury secretary James Baker** was threatening not to support it. The next day, the crash.



Only ten weeks on the job, **Fed chair Alan Greenspan** lowered rates twice after the crash, in an easing mini-cycle lasting seven months. Ironically, a stock market decline based on fears that the Fed wouldn't be aggressive enough turned into a crisis that made the Fed *less* aggressive -- the market caused the very thing it feared. As Greenspan cut rates, gold moved on to new highs, and the dollar fell through its Louvre floor to new lows. And core CPI inflation continued to rise. But after the tightening cycle resumed in force, all that eventually reversed. Stocks recovered smartly -- they climbed in tandem with the fed funds rate for the next 15 months as the inflationary acceleration was ultimately conquered.

We could be in a similar situation today. As my colleague **David Gitlitz** pointed out in a report on Tuesday, just because the Fed is expected to embark on a new tightening cycle as soon as the June 30 **FOMC** meeting, and just because gold and forex have come off their worst inflation-alarm levels, it doesn't mean we're out of the inflationary woods (see "What's Up With Gold?" March 11, 2004). Now the Fed has to actually follow through. A great inflation number Friday, or a bad jobs number in June -- who knows how little it would take to derail the Fed? And who's to say that **George Bush's** accelerating PR fiasco over **Abu Ghraib** won't stay the Fed's hand, the way the crash did in 1987? Don't forget: the Fed is *already* late. TM