# Weekly Market Commentary

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## Counting Down the Months

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### Highlights

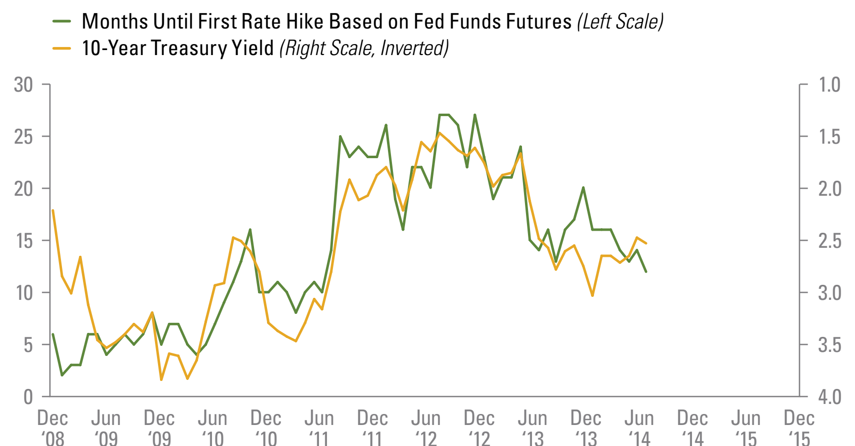
A common worry among investors is that the stock market may fall as the Fed gets closer to hiking rates. In fact, the S&P 500 has posted a gain in the 12 months ahead of the first rate hikes over the past 35 years.

After five-and-a-half years of keeping short-term rates in a range of 0–0.25%, many market participants believe the Federal Reserve (Fed) is now about 12 months away from hiking interest rates. This may affect markets in the months and quarters ahead as investors begin to brace for a change in policy.

Over the five-and-a-half years since the Fed took the federal funds rate down to a range of 0–0.25% on December 16, 2008, participants in the fed funds futures market have had varying views on when the Fed may begin to raise rates for the first time. Figure 1 shows the number of months until the fed funds futures yield will move above the 0–0.25% range priced into the futures market at the end of each month. Figure 1 also shows the 10-year Treasury yield (shown with an inverted scale), revealing how in sync long-term bond yields have been with the outlook for short-term rate moves by the Fed.

With the participants in the futures market pricing in the first rate hike at 12 months away, 10-year Treasury yields should be between 2.5% and 3.0%, based on the past five-and-a-half year relationship between them. The 10-year yield is at the low end of that range now. However, if this relationship persists and the year ends with market participants still thinking the Fed will hike rates in July 2015, the 10-year yield may end this year in a range of 3.0–3.5%. Of course, the markets have been wrong repeatedly over the past five years on how soon the Fed may hike rates.

1 Long-Term Bond Yields in Sync With Outlook for Fed Short-Term Rate Hike




Source: LPL Financial Research, Bloomberg data 07/14/14

Past performance is no guarantee of future results.

The potential for a rise in rates may put pressure on the returns from bonds and interest rate sensitive stocks, as has historically been the case in the year before the first rate hike. Looking back at the seven different times the Fed began to hike rates over the past 35 years, the 10-year Treasury yield rose each time, putting downward pressure on bond prices. Also, the three weakest sectors of the stock market were utilities, financials, and telecommunications services, on average, during the year before rate hikes began.

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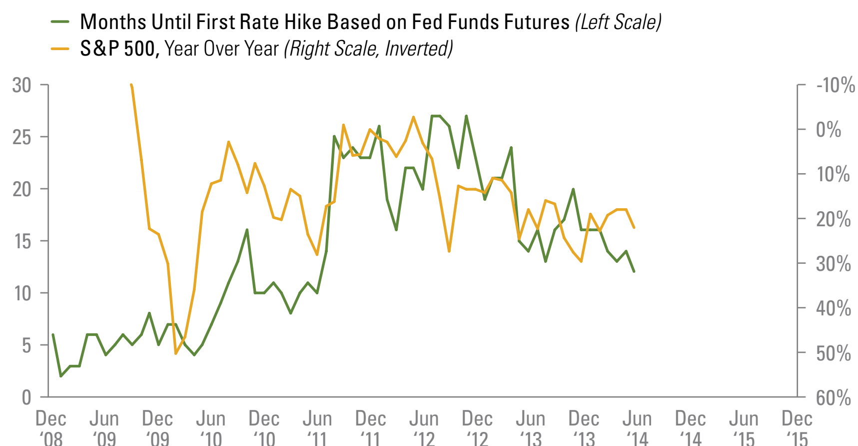
Moreover, the stock market does not appear to be prepping to deviate from that pattern this time, as you can see in Figure 2. In fact, although the fit between the number of months until the first rate hike is anticipated and the performance of the S&P 500 (with scale inverted) is not nearly as tight as it is with bond yields, the relationship points more toward the year-over-year return on the S&P 500 accelerating as the months tick down, rather than falling. We expect that while the S&P 500 is unlikely to soar above the pace of gains seen in the past 12 months, the year ahead is likely to see solid gains.

2 Stock Market Pattern May Suggest Gains as Fed Hikes Near




Source: LPL Financial Research, Bloomberg data 07/14/14

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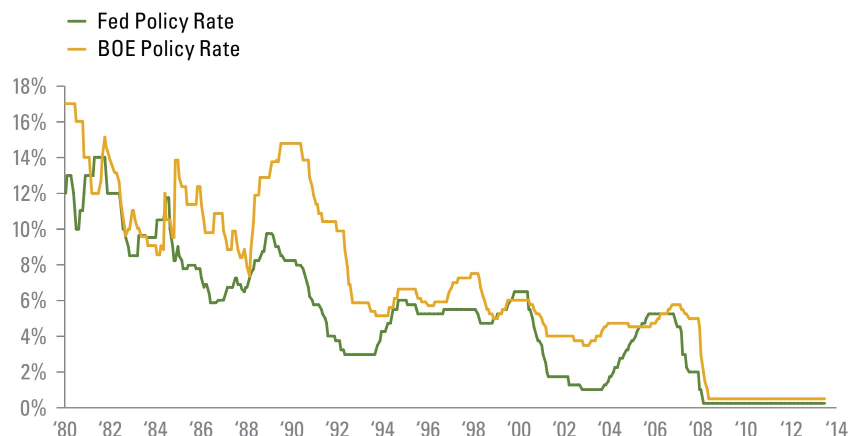
Over the past 35 years, periods of rate hikes have been synchronized among the world's central banks—especially between the United States and the United Kingdom, as you can see in Figure 3. The United Kingdom provides a current example of stocks performing well ahead of an anticipated initial rate hike. The Bank of England is widely expected to be the first major central bank to hike rates, raising them from the 0.5% they have maintained for over five years, and the FTSE 100 Index has still posted modest gains so far this year.

3 U.S. and U.K. Monetary Policy Usually in Sync




Source: LPL Financial Research, Bank of England, Bloomberg data 07/14/14

U.S. main policy rate (federal funds target rate and discount rate prior to Oct. 1982) and U.K. main policy rate (minimum lending rate prior to Aug. 1981; Minimum dealing rate until May 1997; Repo rate until Aug. 2006; Official bank rate through present)

As the countdown of the months to an initial rate hike continues, stocks may perform well using history and current comparisons with anticipated actions from other central banks as a guide. However, those sectors more sensitive to rising interest rates may lag the overall market. ■

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stock representing all major industries.

The FTSE 100 Index is comprised of the 100 most highly capitalized blue chip companies listed on London Stock Exchange.

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