

# Rising Rates and Stocks: A Historical Perspective

The Federal Reserve has a significant influence on the financial markets. It is widely believed that the central bank's massive bond-buying program coupled with an unprecedented period of near-zero interest rates fueled the six-year bull market for stocks. Now all eyes are again on the Fed, as anxious investors wait for news of when -- and by how much -- the Federal Open Market Committee (FOMC) will raise short-term rates, and what that action will mean for stocks.

While heightened volatility is often a byproduct of the Fed initiating a restrictive monetary policy -- i.e., raising rates -- there are unique variables at play this time that may help to ease investor angst.

At the very least, a rate hike will indicate a turning point in central bank monetary policy, which could spark additional market volatility. Beyond that, what rising rates might mean for stocks is speculative, yet history provides a window into what could transpire.

## Historical Trends -- A Mixed Bag

Over the past 20 years the Federal Reserve has initiated rate hike cycles three times -- in April 1997, July 1999, and June 2004. In each of these periods, stocks experienced an immediate or near-term decline that was followed by a longer rebound.<sup>1</sup>

Other research that looked at the past 35 years (and six rate-hiking cycles) found that stocks don't follow a straight path up or down in reaction to a rate hike. Instead, they present a mixed bag of performance. For instance, analysis reported on CNBC.com found that in two of the six cycles, stocks, as represented by the S&P 500, were lower a year after the initial rate hike. Even so, the average gain for all six periods was 2.6%. And on average, a year and a half after the first rate hike in a cycle, the market was up 14.4%.<sup>2</sup>

Another key factor affecting the movement of stocks in relation to interest rate hikes was where in the business cycle the economy might have been when the rate increases commenced. For instance, Fidelity reports that, based on historical averages, most rate hikes have started in the middle of the business cycle when the economy is growing and corporate profits are positive. In these cases, investments have tended to produce positive returns. As the cycle matures, however, returns begin to diminish.<sup>3</sup>

## What's Different This Time?

While heightened volatility is often a byproduct of the Fed initiating a restrictive monetary policy -- i.e., raising rates -- there are unique variables at play this time that may help to ease investor angst.

With the federal funds rate set at 0% to .25% for nearly seven years -- far below its

starting point for the previous several rate hiking episodes -- it is believed that the FMOOC has a lot of leeway to move rates up before creating a significant drag on the economy. Further, many economists and Wall Street analysts expect that when the Fed does begin raising rates for the first time since the Great Recession, it will take a very measured approach to its rate-hiking schedule, paying close attention to the leading indicators commonly used to project potential future inflation and/or economic growth.

### Takeaways for Investors

Given the inevitability of an interest rate hike looming on the not-too-distant horizon, you may be rightfully cautious in your outlook for your stock portfolio. But don't let your emotions get in the way of potential investment opportunities. Consider discussing the following strategies with your financial advisor at your next meeting.

- Buy on the dips. If stocks do swoon when the Fed acts, many analysts feel the drop will be short-lived and may in fact prove to be a good time to selectively add to your portfolio. A systematic purchasing plan, also known as dollar cost averaging, can help in volatile times, as it provides for regular purchases over a period of time, taking the guesswork out of specific timing of purchases.<sup>4</sup>
- Consider high-quality, dividend stocks. Equity investors looking to limit volatility may want to consider an income-producing strategy via dividend-paying stocks. Although a company can potentially eliminate or reduce dividends at any time, a dividend may provide something in the way of a return (i.e., income plus any potential price appreciation) even when stock prices are volatile. When evaluating dividend-paying stocks, it may be worthwhile to review how long a company has paid a dividend, whether the dividend has increased over time, and how much leverage the company may have to raise the dividend further.
- Review sector allocations. History supports the notion that Fed actions affect equity sectors in different ways. For instance, in a restrictive cycle, defensive sectors, such as utilities, energy, consumer staples, and health care have tended to perform better, as these sectors produce necessary goods and services that have less reliance on consumer discretionary spending. In an expansive cycle, leading sectors tend to be those that are more dependent on consumer spending, such as retail, apparel, autos, and construction.<sup>5</sup>

These are just a few of the strategies you may want to consider heading into a rate-hiking cycle. Work with your financial advisor to review your unique circumstances and make changes, as deemed appropriate, for your situation.

<sup>1</sup>Wealth Management Systems Inc. For the periods indicated. Stocks are represented by the S&P 500, an unmanaged index generally considered representative of stock market performance in the United States. Past performance

does not assure future results. Investors cannot invest directly in any index.

<sup>2</sup>*CNBC.com* and Nuveen Asset Management, "When the Fed raises rates, here's what happens," September 17, 2015.

<sup>3</sup>Fidelity, "First rate hike; what you need to know," September 9, 2015.

<sup>4</sup>Dollar cost averaging involves regular, periodic investments in securities regardless of price levels. You should consider your financial ability to continue purchasing shares through periods of high and low prices. This plan does not assure a profit and does not protect against loss in any markets.

<sup>5</sup>*Forbes*, "How Rising Interest Rates Will Affect The Stock Market And Your Investments," May 19, 2015.