Investment Policy

PaineWebber

# Another Tight Squeeze?

## If the Fed hikes rates, what could it mean?

**Highlights**

■ What *if* the Fed raises rates? Still look for S&P 500 year-end 2000 fair value of 1400, equivalent to DJIA 11,500.

■ Stocks usually have been higher three, six and 12 months after a Fed hike—+5%, +7% and +10% respectively. What typically *initially* develops is a tug-of-war between rising rates and rising earnings as, during tightening, strong profit growth leads to upward revisions in earnings power. Normal EPS were, on average, 5% higher six months after the first Fed hike, and 13% higher twelve months later.

■ Today the risk is actually a synchronized global economic boom leading to *successive* Fed tightenings. If Fed's successive tightenings stop growth, that could *ultimately* push earnings down and, in turn, lower market's normal value. Against lowered earnings expectations and higher rates, with market still a little overvalued, a 10-15% market fall could not be ruled out, but such a scenario seems unlikely.

Déjà vu?

Consider:

- Concerns about an increase in the Fed funds rate following an upcoming FOMC meeting.
- Real GDP running at close to a 4% annual rate.
- Fears that an overheating economy will lead to a buildup in inflationary pressures.
- A pickup in corporate profit growth to a double-digit pace after a year of just single-digit gains.
- A stock market fairly valued on a P/E basis, but vulnerable versus long-term interest rates, with our asset allocation model gauging the probability that stocks outperform bonds at around 30%.

Sound familiar? Yes, that was March 1997.

Two years ago the economic and investment environment was remarkably similar to that of today. And, as is now the case, investors awaited the outcome of a key FOMC meeting. PaineWebber's Chief Economist, Dr. Maury Harris, now believes that an increase in the Fed funds rate is likely sometime this summer. As we did two years ago (see "A Tight Squeeze?" March 23, 1997), it seems worthwhile, once again, to consider what *would* be the *likely* implications of any such tightening.

A 25-basis-point firming in the targeted Fed funds rate would likely boost short-term rates (T-bills, etc.) by 25 or more basis points, as the markets begin to price in the possibility of yet *further* tightening. And while over the longer term it should lower long bond yields—reflecting the disinflationary, destimulative effect—in the near term the mechanics of a higher 'cost of carry' for trading accounts could lead to a sell-off in bonds, and rising yields.

As for the stock market, a tightening not only would raise the relative attraction of fixed-income securities for asset allocators, it could threaten the outlook for continued corporate profit growth in 2000 and, more likely, 2001. But as the analysis below (from "A Tight Squeeze?") suggests, it would probably take a *series* of tightenings for this "worst case" scenario for equities to come true. And any *initial* tightening would not come as much of a surprise today, likely having been already discounted by the stock market.

June 20, 1999
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*Chart 1*

Fed funds rate and discount rate

*with first period of tightening shaded*

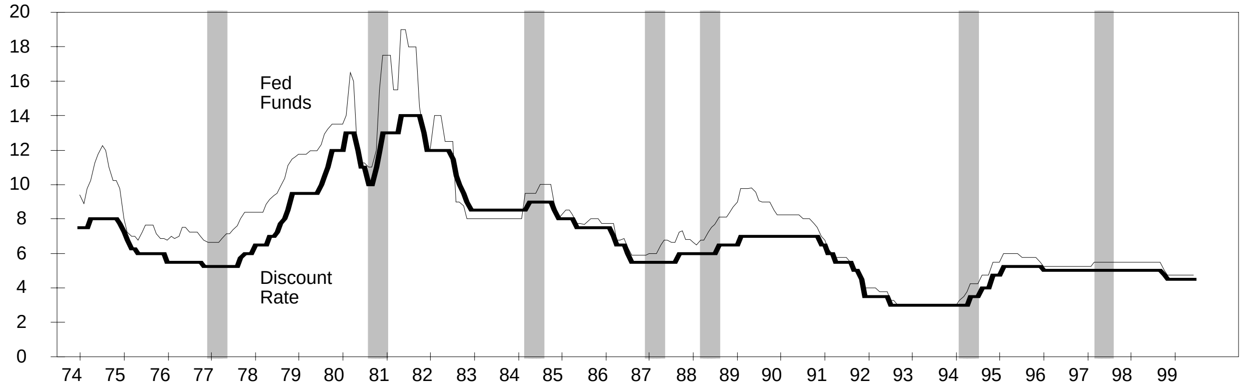



*Chart 2*

S&P 500 price

*with first period of tightening shaded*

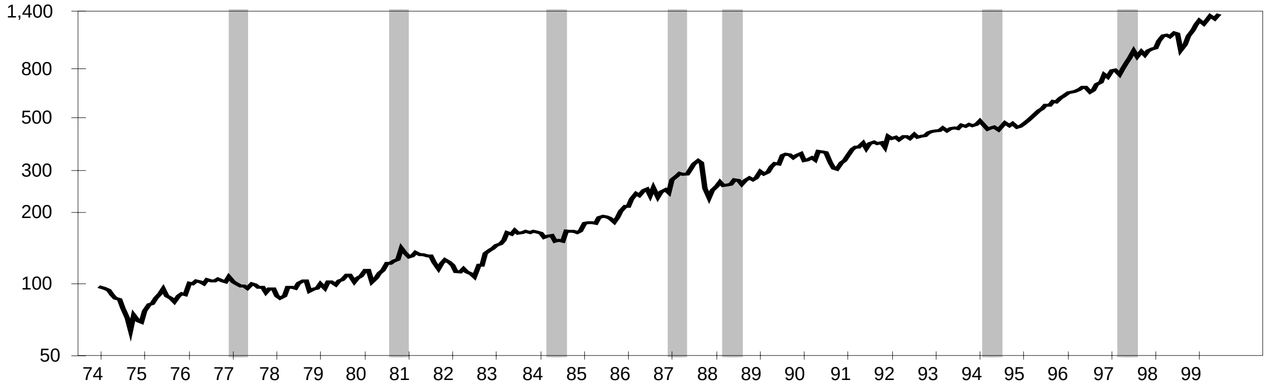
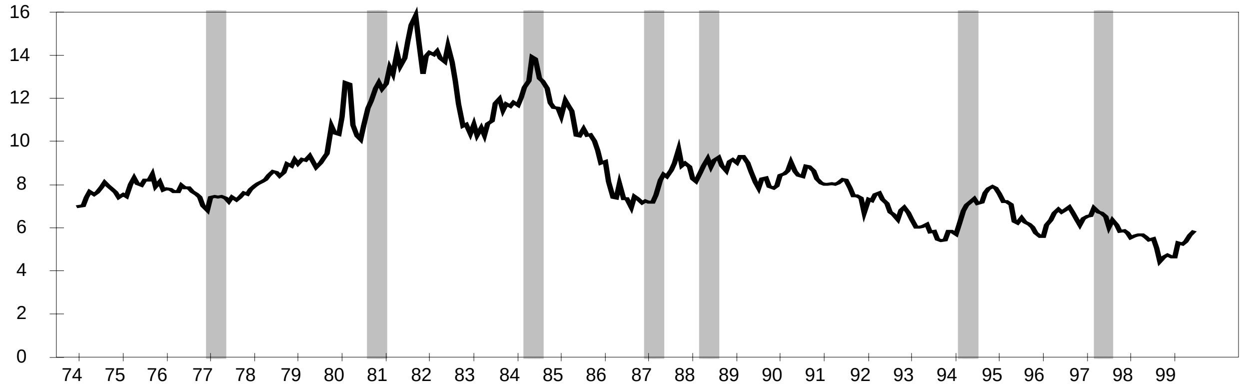



*Chart 3*

10-year Treasury bond yield

*with first period of tightening shaded*




Source: PaineWebber and DRI.

Table 1 lists the seven recent periods when the Fed raised rates *after a long period of easing*. In the table we also show the change in stock prices and in 10-year bond yields three, six and 12 months following the initial rate increase. The important conclusion is that, while bond yields rose steadily following prior rate hikes, *stock prices were, on average, modestly higher 12 months after the first increase.*

To place the current situation in context, it is worth noting what was happening during these previous rounds of Fed tightening:

- 1976: The Fed continually tightened to curb inflation, but it constantly underestimated economic strength and inflationary pressure. Inflation rose from 5% in 1976 to 12% in 1980.

*Table 1*

Fed Funds hikes

*Impact on stock prices, bond yields*

| Date of 1st hike | # of changes | Fed Funds total rise | Change | +3 months | +6 months | +12 months |
|---|---|---|---|---|---|---|
| Dec. '76 | | | S&P 500 | -1.8% | -5.4% | -7.6% |
| | 32 | +1075bp | 10-yr bond | +52bp | +41bp | +61bp |
| Aug. '80 | | | S&P 500 | +4.8 | +5.9 | +6.9 |
| | 8 | +1050 | 10-yr bond | +195 | +238 | +412 |
| Mar. '84 | | | S&P 500 | -3.1 | +5.4 | +15.8 |
| | 5 | +225 | 10-yr bond | +163 | +78 | -10 |
| Dec. '86 | | | S&P 500 | +20.5 | +25.5 | +2.0 |
| | 4 | +140 | 10-yr bond | +30 | +141 | +164 |
| Mar. '88 | | | S&P 500 | +5.6 | +5.0 | +13.9 |
| | 9 | +325 | 10-yr bond | +33 | +39 | +73 |
| Feb. '94 | | | S&P 500 | -3.9 | -2.4 | +1.9 |
| | 7 | +300 | 10-yr bond | +125 | +124 | +163 |
| Mar. '97 | | | S&P 500 | +12.7 | +18.9 | +39.6 |
| | 1 | +25 | 10-yr bond | -32 | -64 | -112 |
| Average | | | Avg. S&P | +5.0% | +7.6% | +10.4% |
| | 9 | +450bp | Avg. 10-yr | +81bp | +85bp | +107bp |
| Avg. ex. '97 | | | Avg. S&P. | +3.7% | +5.7% | +5.5% |
| | 11 | +520bp | Avg. 10-yr. | +100bp | +110bp | +144bp |

Source: PaineWebber.

- 1980: Paul Volcker replaced G. William Miller as Fed Chairman in 1979 with the mission of killing inflation. He raised rates further and triggered a short, sharp recession in 1980 which, however, did not succeed in ending the wage-price spiral. So, in August 1980 he tried again. Repeated tightening produced the deep recession of 1981-82 that triggered deflation in oil and other commodities and ushered in a secular disinflationary trend.
- 1984: Despite high real interest rates, the recovery that began in 1983 was surprisingly robust, as consumers celebrated the first extended period of low inflation in a decade. During the year ended Q1 1984, real GDP grew 8.2%. Intent on maintaining his hard-won gains against inflation, Mr. Volcker tightened in the spring of 1984. But extended tightening was not necessary because GDP growth was slowed by the surge of the U.S. dollar. (The trade-weighted dollar rose 31% during the two-year period ending Q1 1985.)
- 1986: The strong dollar of 1984-85 and oil price crash of 1986 (which produced a contraction in the "oil patch") caused an economic slowdown in 1985-86. Real GDP rose just 0.3% in Q2 1986. Therefore the Fed eased aggressively even as the dollar declined from its Q1 1985 peak. These two stimulative forces set the stage for economic acceleration that started in late 1986. Accordingly, the Fed adopted a less accommodative monetary stance at that time.
- 1988: Following the October 1987 stock market crash, the Fed eased for two reasons: to prevent an implosion of the financial system, and to ward off the recession that, it was widely feared, the crash itself would produce. However, the crash had far less impact on Main Street than Wall Street, and the economy continued to grow rapidly. So, in the spring of 1988 the Fed began to tighten again to restrain the economy as it moved toward full capacity.
- 1994: Partly because of the bank credit crunch and the impact of corporate restructuring, the economic expansion that began in 1991 was extremely anemic, leading to fears of a "double dip." To protect the expansion, the Fed was very accommodative in 1992-93. By the spring of 1994 easy money had revved up economic activity, and the Fed shifted from an accommodative to a neutral stance.
- 1997: As discussed above, two years ago the economy's strong performance was the primary catalyst behind the Fed's tightening. But while growth remained strong *after* the Fed's tightening (GDP for the year rose at a 3.9% rate, while the unemployment rate fell to 4.9% from the prior year's 5.4%), inflation decelerated, with the CPI slowing from 2.9% in 1996 to 2.3% in 1997, while the PPI rose at just a 0.4% rate, compared to 2.6% in the prior year. The benign inflation environment, as well as the Asian crisis that got underway in the fall of 1997, averted any further Fed tightening.

## One (or two) and done?

As noted, Table 1 reveals that, on average, bond yields rose steadily following prior rate hikes, although stock prices were typically higher 12 months after the first increase. The average is, however, distorted by the unusual 1997 period when the Fed raised rates just once. While, in most of the other periods, bond yields were materially higher and stock prices modestly higher 12 months after the first Fed hike, in the 1997 period bond yields were significantly *lower* and stock prices significantly *higher* one year after the initial tightening.

In a scenario similar to that of 1997, today there is the possibility that, rather than a series of tightenings, there will be only one or two Fed rate increases in 1999:

- First, inflation remains benign. While inflation was unusually benign in 1998 (PPI of -0.9%, GDP Price Index of +1.0%, CPI of +1.6%), recent reports do not indicate that inflationary pressures are about to pick up materially any time soon. Remember, the Fed's charter is to promote growth while maintaining price stability; with inflation under control (May's PPI rose just 0.2% while the CPI was unchanged) and growth likely to moderate, a succession of rate increases would run counter to the Fed's charter.
- Second, the *real* Fed funds rate was negative prior to the last period of *extended* Fed tightening in 1994. Today's positive real rate environment argues against a series of rate hikes.
- Third, a succession of interest rate hikes would propel the dollar even higher, particularly against the already-battered euro.

### Global boom?

But the risk actually is a synchronized global economic boom. With both Japan and Germany—the two large laggards—recently reporting surprisingly strong growth, there is the growing potential that 2000 might see not just renewed global growth, but a true global boom. Under such a set of circumstances, the Fed would have increased reason to tighten, and to continue to tighten aggressively.

### Tug-of-war

Under a "global boom" scenario, what likely would *initially* develop would be a tug-of-war between rising rates and rising earnings. Interestingly, over the past quarter century, as shown in Table 1, that tug-of-war has usually resulted in higher stock prices, but never sharply lower prices. That's probably because during periods of Fed tightening strong profit growth usually leads to successive upward revisions in earnings power. For the seven periods listed in Table 1, normal EPS were, on average, 5% higher six months after the first Fed hike, and 13% higher twelve months after the first increase.

From an earnings perspective, just one rate hike certainly would not be enough to change our view that S&P earnings will grow around 10% in 1999 and 2000:

- For one thing, the Fed would be tightening because the economy is strong, which is bullish for profits.
- Furthermore, monetary policy operates with a lag, and a tightening in the summer would not have much impact until early 2000 at the earliest.

### It's all up to rates

We still expect S&P 500 year-end 2000 fair value of 1400, equivalent to DJIA 11,500. *If* the Fed hikes rates just once, as was the case in 1997, this certainly would not be enough to change the profit outlook. But if successive tightenings by a Fed determined to *slow* growth did *stop* growth, that *could* ultimately cut normal earnings power and cause the market's *normal* value to drop. And against lowered earnings expectations *and* higher rates a market 5-10% undervalued could not be ruled out. Ergo, with the market still a little overvalued, a 10-15% market fall could not be ruled out.

This bearish scenario remains unlikely, with the "one (or two) and done" scenario still more likely, suggesting normal stock market returns over the next 12-18 months in an already fairly valued market. The stock market is currently at around 105% of fair P/E value. But, Fed policy notwithstanding, a repeat of the strong gains in both the stock and bond markets that occurred in 1997-98 is very unlikely. The secular decline in inflation and bond yields is largely over, and so too is the P/E expansion that propelled stock prices higher in recent years.

The most likely scenario is normal returns from stocks over the next 12-18 months, with that scenario being predicated on an assumption of just one (or two) Fed tightenings (not adversely affecting earnings power), and eventually a big bond market rally. The probability that stocks outperform bonds has fallen to 33%, a two-year low. So, for stocks, it's now up to the Fed and the bond market.



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