Chart of the Month

May 2014

Headline from Tuesday: Stocks decline sharply amid Fed rate talk. Dow down triple digits.

The Dow Jones Industrial Average dropped to a five-week low after Charles Plosser, the president of the Federal Reserve Bank of Philadelphia, warned in a Washington speech yesterday that a strengthening U.S. economy may force the central bank to hike rates “sooner rather than later.” Plosser, a noted hawk when it comes to interest rates, said the Fed is at risk of falling “behind the curve” in its control of inflation if monetary policy doesn’t tighten as the economy and labor market continue to improve.

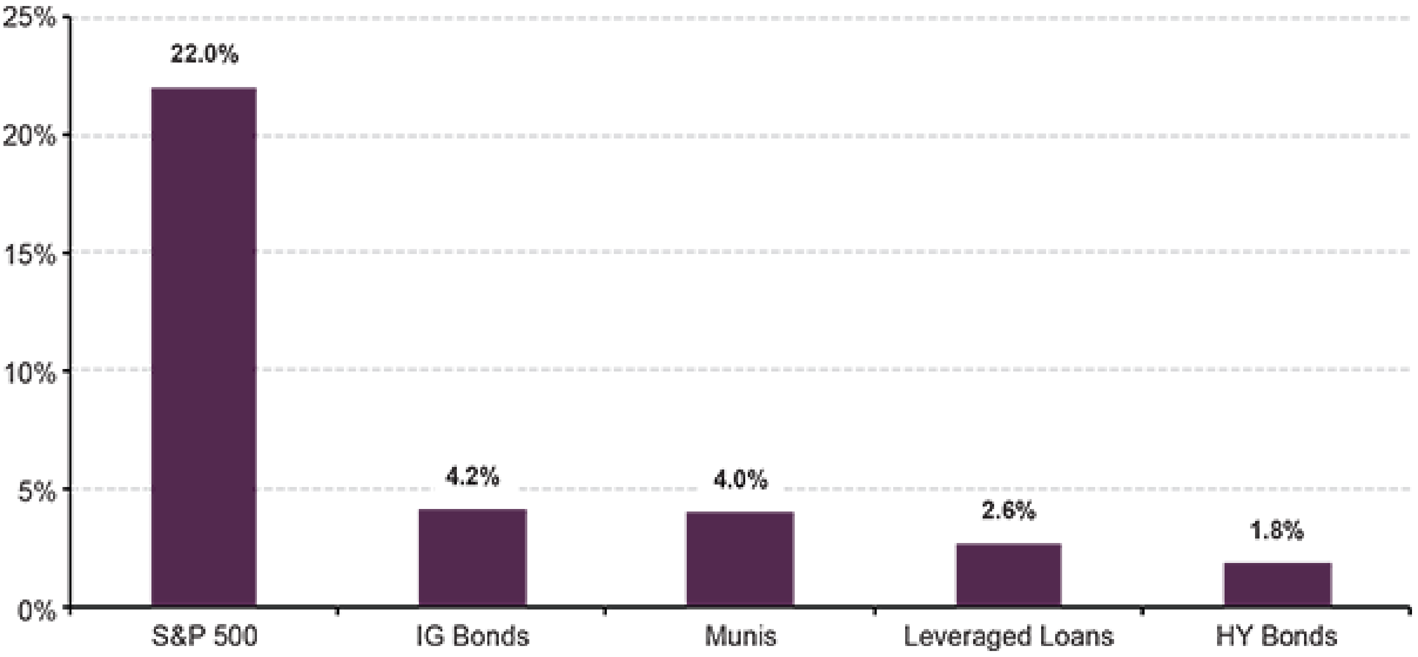
In Janet Yellen’s inaugural press conference as the head of the Federal Reserve earlier this year, she indicated that the central bank may start raising the fed funds rate six months after ending its bond purchasing program. The Fed has gone from buying $85 billion per month back in December to $45 billion per month. At its current pace of tapering, the Fed is likely to conclude its asset purchases shortly before or after Thanksgiving.

Based on Yellen’s comments, the Federal Open Market Committee could decide to lift the funds rate in April or June next year. If so, should we expect the stock market to decline in anticipation of these rate increases down the road?

Well, as shown in the graph below, the S&P 500 has *gained* an average of 22.0% in the 12 months prior to the past five Fed tightening cycles in 1983, 1986, 1994, 1999, and 2004. In the most recent series of rate increases, the central bank began raising the level of fed funds on June 30, 2004. Of note, the S&P 500 *rose* 19.0% in the 12 months leading up to that first rate adjustment. The Fed proceeded to bump the fed funds rate by 0.25% 16 more times over the course of the next two years, taking it up from 1.00% to a high of 5.25% on June 29, 2006. In the face of rising short-term interest rates, the S&P 500 *climbed* 15.5% from the middle of 2004 to the middle of 2006.

While the past is not necessarily prologue, we are not particularly concerned about the outlook for the stock market over the foreseeable future. At the same time, we do not assume that the S&P 500 will advance 22.0% over the next year because the Fed actions have been so telegraphed this cycle the outsized returns are much less likely than in previous periods. Nonetheless, we believe the market could still surprise the naysayers by generating total returns of approximately half of the historical results (or roughly 11.0%) based on a combination of growing earnings and dividends.

AVERAGE PRICE PERFORMANCE
During the Year Before Fed Tightening



Source: Credit Suisse, Barclays, Bloomberg, Guggenheim Investments.

Lederer & Associates
Investment Counsel

111 West Ocean Boulevard, Suite 1350, Long Beach, California 90802
Tel: (562) 495-2350 ▲ Fax: (562) 495-2006
www.lederer-associates.com