Chart of the Month

May 2015

The minutes from the Federal Open Market Committee's April 28-29 meeting were released on Wednesday and the consensus opinion among policymakers was that it would be premature to raise interest rates in June as some pundits had previously predicted. Fed officials believe the U.S. economy will pick up after a slowdown in the first quarter that reflected, in part, transitory factors such as bad weather and a port disruption. The FOMC will assess on a "meeting-by-meeting" basis whether to raise rates with some members telegraphing September for the first increase in the fed funds rate since 2006. Meanwhile, the futures market, which places less than a 25% likelihood on the Fed boosting rates in September, is betting on a rate hike in December or January.

While the timing of a rate increase has been pushed out at least a few months, it is important to comprehend the historical impacts of such increases on the stock and bond markets before they occur. Accordingly, our Chart of the Month focuses on the behavior of the S&P 500 and the 10-Year U.S. Treasury Yield during the three previous Fed rate hike cycles.

As shown below, the results have been mixed but stock prices and bond yields have tended to rise during the periods of Fed tightening. Stocks gained at least 10% in all three cycles with no more than a 10% interim correction along the way. The S&P ramped to the upside in the late stages of the February 1994-March 1995 cycle and marched higher in stair-step fashion with the funds rate in both the June 1999-June 2000 and June 2004-July 2006 cycles.

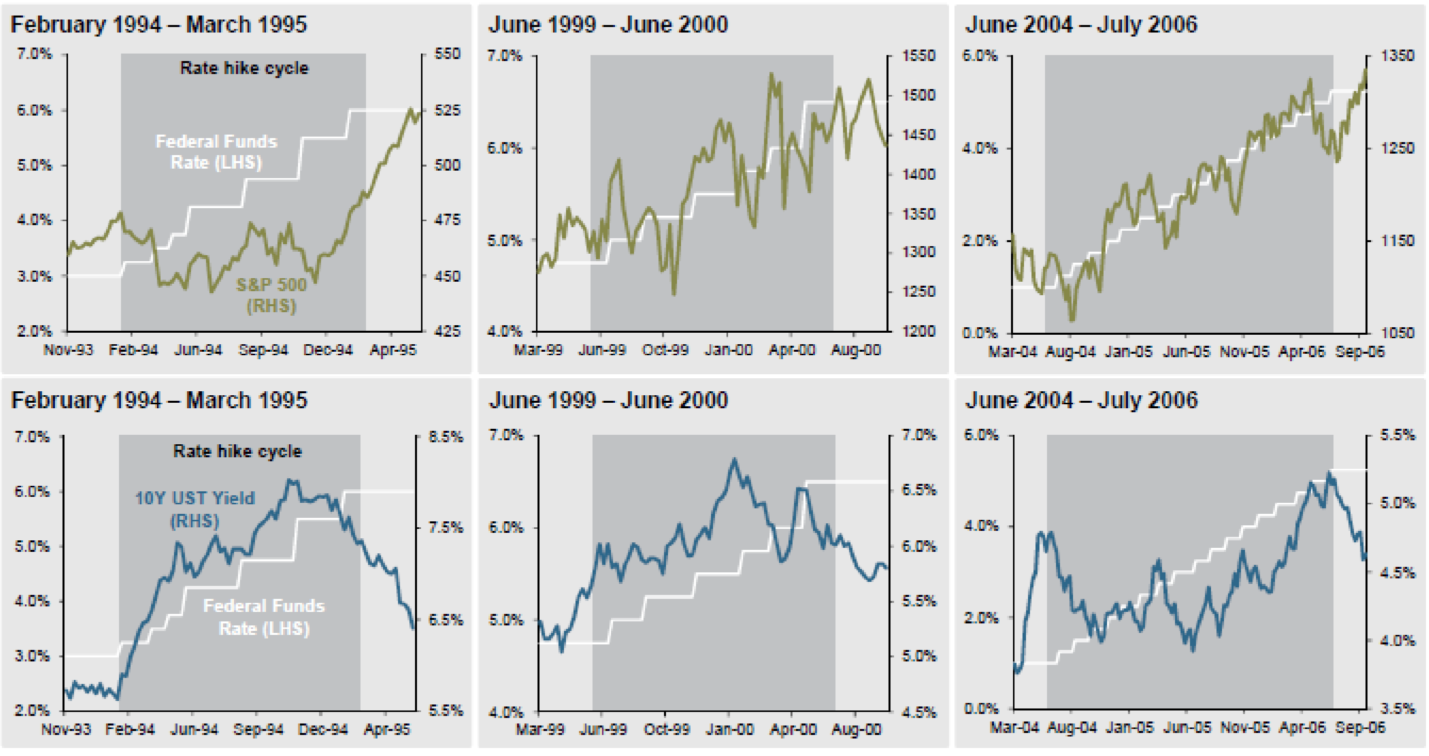
Yields on the 10-Year Treasury rose in conjunction with the increases in rates during 1994-1995 and 1999-2000. However, the yield was more than halved during the initial rate hike cycle in 2004, virtually negating the entire rise that happened in anticipation of the Fed's move. Of note, bond yields plunged after the Fed completed its programs in 1995, 2000, and 2006.

Corporate bonds – our fixed-income vehicle of choice – may hold up better than their government counterparts in the early stages of a rate hike cycle because the strengthening credit metrics should result in a narrowing of spreads, partially offsetting the rise in yields. We would also argue that client portfolios stand to benefit from an environment of rising rates given that our average maturity is only three to four years and as short as two when the probability of calls are included. As bonds mature or get called, we will be in a great position to reinvest the proceeds at higher yields should rates rise in the future.

Recognizing that history is only a guide, we remain vigilant in monitoring the economy, company fundamentals, and valuations on an ongoing basis. We are braced for the possibility of increased volatility in both stock and bond prices down the road yet mindful that the Fed is only considering rate hikes because the economy is healthier than it has been in years. As such, investors should welcome rather than fear the normalization of interest rates, especially from such low levels.

Returns and Yield Changes During Rate Hiking Cycles

S&P 500 price index and 10-Year U.S. Treasury yield over the last three rate hiking cycles



Source: Standard & Poor's, FactSet, J.P. Morgan
Data are as of March 31, 2015.

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