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Archival Edition

Charles Schwab
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Perspectives™

Rate hikes & stocks: A bullish history

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Important disclosure: This document was previously published and is being made available as an example of Charles Schwab Investment Management's "Body of Work." All information was considered timely when the document was initially published; however, as this point, neither the data nor subject matter discussed should be considered current.

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This discussion reflects the views of ***Omar Aguilar*** *and* ***Emre Erdogan****.*

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The U.S. economy has improved, and the Federal Reserve (Fed) seems poised to shift its policy gears and start "normalizing" interest rates later this year. As a result, we expect stock market volatility to increase overall, particularly around scheduled Fed policy meetings. The increase in volatility aside, stocks have generally performed well leading up to and after Fed rate hikes. History could repeat itself this time around, which makes this a good time to consider the important role that equities can play in a well-balanced portfolio.

The Fed: Shifting toward normalization

Shifting policy gears

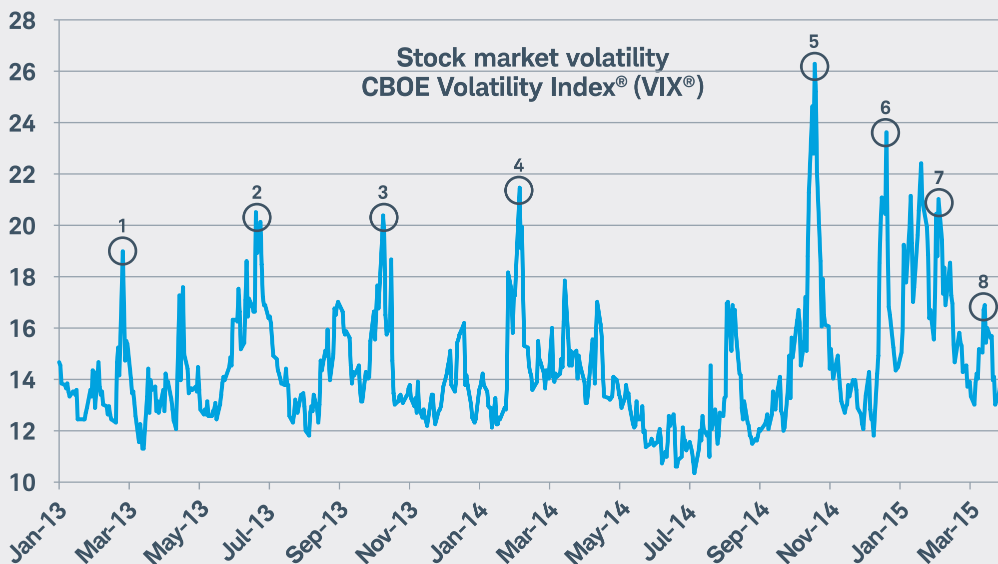
Fed discussions about higher interest rates have featured prominently in recent headlines. With the 2007-2008 credit crisis behind us and the U.S. economy in much better relative health, investors are trying to gauge when the Fed will officially shift its policy gears. Any such shift will likely have repercussions across all asset classes, although these repercussions may differ broadly from one asset class to another. Ahead of this environment, market volatility has been on the rise. We believe that this trend could continue for some time, with volatility potentially increasing around scheduled Fed policy meetings.

Heightened volatility possible

The chart below helps to illustrate this trend. Since the start of 2013, most of the jumps in the Chicago Board Options Exchange (CBOE) Holdings Volatility Index® (VIX®)—a widely watched gauge of stock market volatility—happened around the time that Fed officials commented on adjusting their interest rate policies. This included the Fed's quantitative easing efforts aimed at holding down long-term interest rates, as well as the market's current focus, which is on the federal funds rate target—a short-term interest rate benchmark that affects many financial market rates.

> For now, we expect market volatility to continue, and probably increase around the time of scheduled Fed policy meetings.

Fed speak fuels market volatility



1. Concerns that the Fed will cut short its QE program
2. Fed suggests it is closer to slowing QE
3. Most Fed officials forecast QE tapering later in the year
4. Fed presidents say market decline unlikely to derail QE taper
5. Chair Yellen voices confidence in U.S. expansion amid risks
6. Fed signals patience regarding interest rates
7. Fed flags mid-year rate hike, or later, as a possibility
8. Fed expected to remove 'patient' from post-meeting statements

Sources: Bloomberg and CSIM

Stocks could rise with rates

. . . for possible hints about the future.

To help us better understand the potential effects of the Fed's potential policy shift, we identified 11 instances between July 1, 1954, and April 14, 2015, where the Fed changed its policies and began raising rates.[2] Then we computed the average cumulative performance of the S&P 500 Index[3] six months before and six months after the Fed's policy shift.

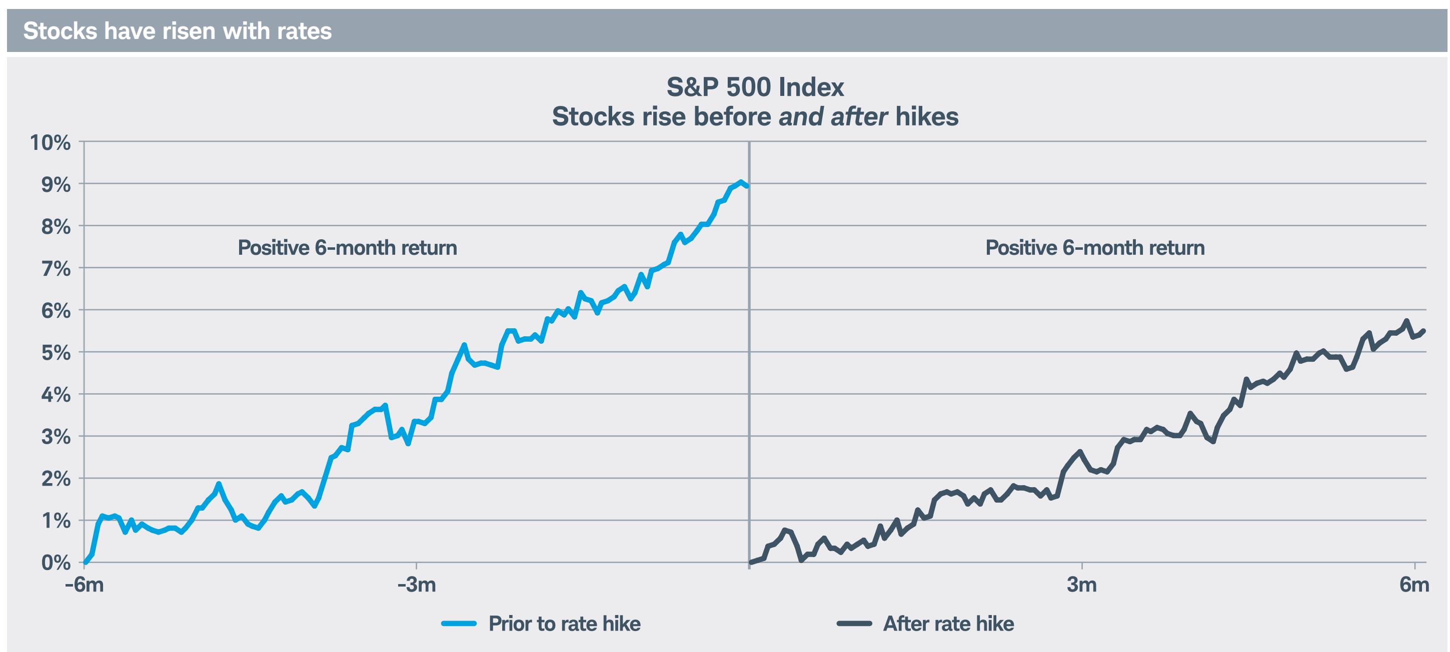
As shown in the chart below, the S&P 500 Index returned an average of 9.0% and 5.5% before and after, respectively, the start of a Fed rate hike campaign. In all 11 of these instances, the S&P 500 Index generated positive returns for the six months before a rate hike. Additionally, market volatility rose around the time of each initial rate increase. In spite of this volatility, the S&P 500 Index generally resumed its upward climb after the rate hikes, generating positive returns in 8 of 11 instances.

Looking at the past . . .

Aside from the possibility of increased market volatility, we believe that equity investors do not need to be overly concerned about short-term interest rate hikes based on our historical analysis. Our research has revealed that since mid-1950s, the S&P 500 Index averaged positive performance both six months before and six months after the Fed began to raise the federal funds target rate.[1]

Since the mid-1950s, the S&P 500 Index averaged positive performance both before and after the Fed began to raise rates.

Stocks have risen with rates



Sources: Bloomberg and CSIM

Looking further down the road

An increase in interest rates would likely reflect overall economic improvement... which bodes well for U.S. equities.

Even though the Fed appears poised to begin "normalizing" interest rates, we don't believe that equity investors should be too alarmed. On the contrary, an increase in interest rates would likely reflect the overall improvement that we've been experiencing in U.S. economic conditions, whether gauged by a national unemployment rate that's hovering around 5.5%, healthier overall economic growth, increased capital spending, or an expansion in the manufacturing sector, which rose for a 29th consecutive month in May. Overall, we believe that such an environment bodes well for U.S. equities, making this a good time to consider the important role that equities can play in a well-balanced portfolio.

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As one of the nation's largest asset managers, our goal is to provide investors with a diverse selection of foundational products that aim to deliver consistent performance at a competitive cost.

[1] The Federal Reserve uses the federal funds target rate as one of its main tools to adjust monetary policies.

[2] For the purposes of this analysis, we used effective federal funds rates before January 29, 1971, as a proxy for the federal funds rate target due to data availability.

[3] For the purposes of this analysis, we used the S&P 500 PR Index, which includes only the price return of the S&P 500 Index and excludes reinvested dividends.

Past performance is no guarantee of future results. Indexes are unmanaged; do not incur management fees, costs, and expenses; and cannot be invested in directly.

The S&P 500 Index is a market-capitalization index that is designed to measure the performance of 500 leading publicly held companies in leading industries of the U.S. economy.

The CBOE Volatility Index® (VIX®) is a leading measure of market expectations of near-term volatility conveyed by S&P 500 Index option prices.

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