

# MRP CAPITAL INVESTMENTS, LLC

## Don't Fight The Fed

Research Report 6/2/2014

## Introduction

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I'm sure everyone reading this report is familiar with the old market saying, "Don't fight the Fed." It simply means that whatever the Fed wants to make happen in the markets, it will. It raises rates when it wants to slow the economy down and, if you believe the saying, the economy then slows down. Of course, the inverse of that is true as well. If the Fed wants to spark the economy, it can. In fact, we've been living through a Fed-induced boom since the financial debacle of 2008.

To review the Fed's actions and their impact on the markets and the economy, we can see that in December of 2008 the Fed took the extraordinary action of setting the Fed Funds rate at 0%. Soon after that, March of 2009 to be precise, the market's bottomed out. In fact, the S&P's intra-day low of 666 was recorded on March 6, 2009. Since then the U.S. economy has grown GDP by \$2.759 trillion and the stock market has rallied 189%.

Given these facts, maybe there is some validity to the "Don't Fight the Fed" mantra. Over the next several pages, I will take a look at some data related to the Fed's actions and see how it has impacted the markets.



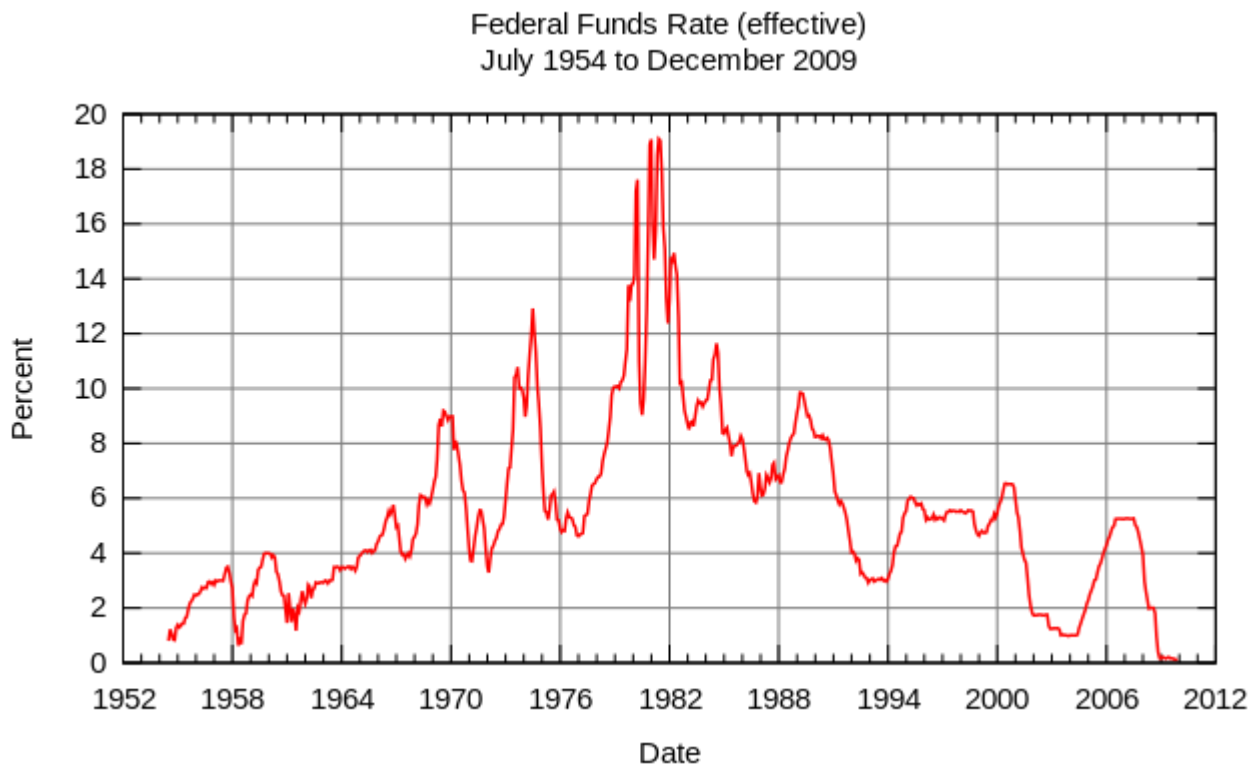
S&P 500 3/6/2009 — 6/2/2014

Chart supplied by Bigcharts.com

## Interest Rate Hikes

The Fed has made it clear over the last few years that it plans to keep interest rates extraordinarily low until at least 2015. Given this stance, and the fact that the Fed Funds rate currently stands at close to 0%, I believe their next move in interest rates will be higher. It is with this understanding that I dove into all the data I could find on the Fed's past interest rate hikes and the impact they've had on the markets.

Looking at this data, I found that since 1971 the Fed has embarked on 8 interest rate hiking cycles. The first was from 1971 and it lasted through July of 1974 and the Fed Funds rate was hiked by 9.5%. The next went from late 1976 until early 1980 and rates moved higher by 15.25%. 1982 saw a less drastic cycle and rates move higher by 3%, 1983 and 1984 saw rates move higher by 3.25%. From December 1986 through February 1989 the Fed moved rates up by 3.75% and from 1994 through 1995 the Fed Funds rate moved higher by 3%. A small interest rate hiking cycle saw rates nudge up by 1.75% in the late 90s and early 2000s, while 2004 through 2006 saw the Fed move the Funds rate upward 4.25%.

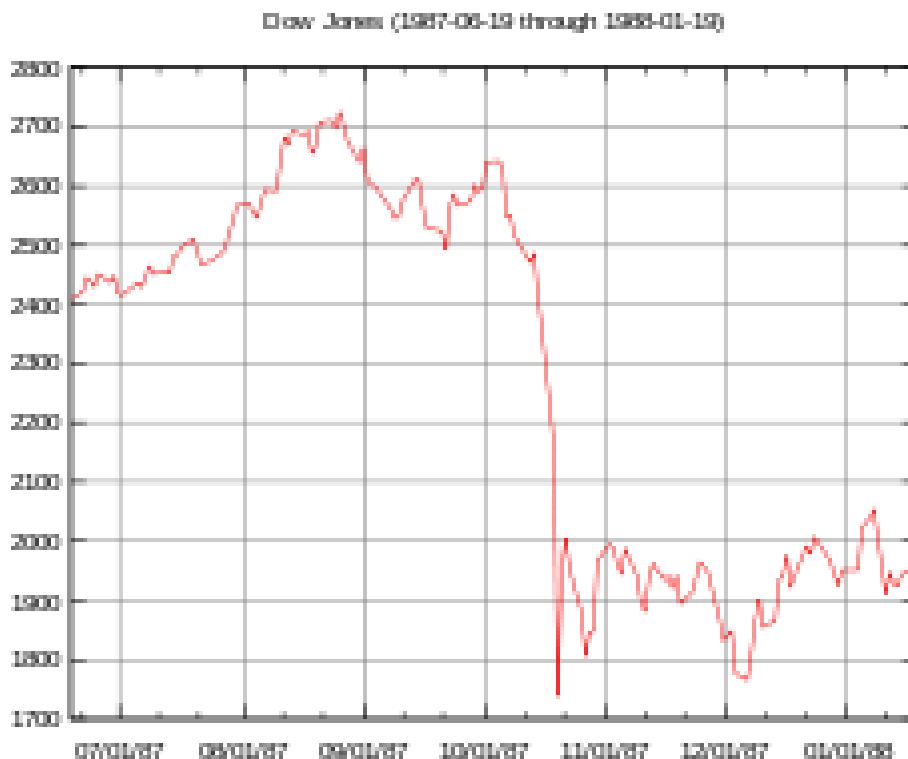


Data provided by the Federal Reserve

## Impact on the Markets

While looking at the data and its impact on the markets, I found quite a few interesting things. The first, and I think most important, is that during all of the eight interest rate tightening cycles that I examined, the average return on the S&P 500 on a purely price basis was 1.97%. Contrast that to the approximate price change of 8% during the entire history of the market and it is clear that **stock market returns during times when the Fed is hiking interest rates will be below average.**

Secondarily, I noticed that 75% of the time during the first 3 months of the tightening cycle the S&P 500 lost value. And THE ONLY time the market showed significant appreciation during the first 3 months of a tightening cycle was the 1986-1989 time frame. What I found most interesting about that cycle was not only did that time frame show significant gains during the first 3 months of tightening, but it also showed big gains through the first 6 months of interest rate hikes. HOWEVER, in just a few months after those gains when the stock market crash of 1987 would unfold. Yeah, you know the one...the one that included Black Monday when the Dow fell almost 25% in one day. Yeah, that one. It seems that market fought the Fed for over 6 months, but eventually and lost BIG!



Data provided by Princeton University

For quick and easy viewing, here is the data related to the average S&P 500 price change given various time frames after the beginning of interest rate hikes by the Fed.

	<u>3 months</u> <u>after hikes begin</u>	<u>6 months</u> <u>after hikes begin</u>	<u>1 year</u> <u>after hikes begin</u>
<b>S&amp;P 500 price change</b>	0.43%	2.20%	2.72%

From this data, you can glean that Fed hikes are not always a complete disaster for the stock market. After all, the Fed is usually raising rates because the economy is doing well. But, in their mind, perhaps too well, and this might stoke inflation. So, they want to contain the market by restricting the growth of the economy. And, with this in mind, the below average gains in the stock market make total sense.

I also want to show you the best and worst market gains during these same time frames and cycles.

	<u>3 months</u> <u>after hikes begin</u>	<u>6 months</u> <u>after hikes begin</u>	<u>1 year</u> <u>after hikes begin</u>
<b>Best S&amp;P price gain</b>	17.66% 1986-1989 cycle	21.24% 1986-1989 cycle	12.60% 1982 cycle
<b>Worst S&amp;P price decline</b>	-10.50% 1982 cycle	-11.39% 1982 cycle	-6.54% 1976-1980 cycle

As you can see, the 1986-1989 cycle (which we've already discussed) showed great gains despite the Fed's actions...until Black Monday.

And the 1982 cycle is interesting because it had the worst early sell off, but a year later it shows the biggest gains. Why? It was the shortest cycle. The rates went up 3.25% in a little over 3 months and then the hikes were over and the market rebounded.

And this fact begs the question, **“What happens when the interest rate hiking cycle is over?”**

Here’s a table detailing the average S&P 500 price change from the time the Fed stops raising rates.

	<b><u>3 months</u></b> <b><u>after hikes stop</u></b>	<b><u>6 months</u></b> <b><u>after hikes stop</u></b>	<b><u>1 year</u></b> <b><u>after hikes stop</u></b>
<b>S&amp;P 500 price change</b>	0.73%	9.53%	18.31%

As you would expect, when the Fed stops tightening monetary policy, the market responds in a positive manner.

Like we did on the last page with best and worst gains during a tightening cycle, I want to look at best and worst gains when the rates stop rising.

	<b><u>3 months</u></b> <b><u>after hikes stop</u></b>	<b><u>6 months</u></b> <b><u>after hikes stop</u></b>	<b><u>1 year</u></b> <b><u>after hikes stop</u></b>
<b>Best S&amp;P price gain</b>	9.17%	19.80%	35.50%
	after the 1994-1995 cycle	after the 1994-1995 cycle	after the 1982 cycle
<b>Worst S&amp;P price decline</b>	-12.44%	-8.51%	-10.04%
	after the 1971-1974 cycle	after the 1971-1974 cycle	after the 1999-2000 cycle

As the data shows, the 70s were a tough time for the markets. Despite the initial hikes stopping, the market didn’t rebound. And, in fact, another hiking cycle began a little over a year later. Inflation was a bear in the 70s and took its toll on the markets.

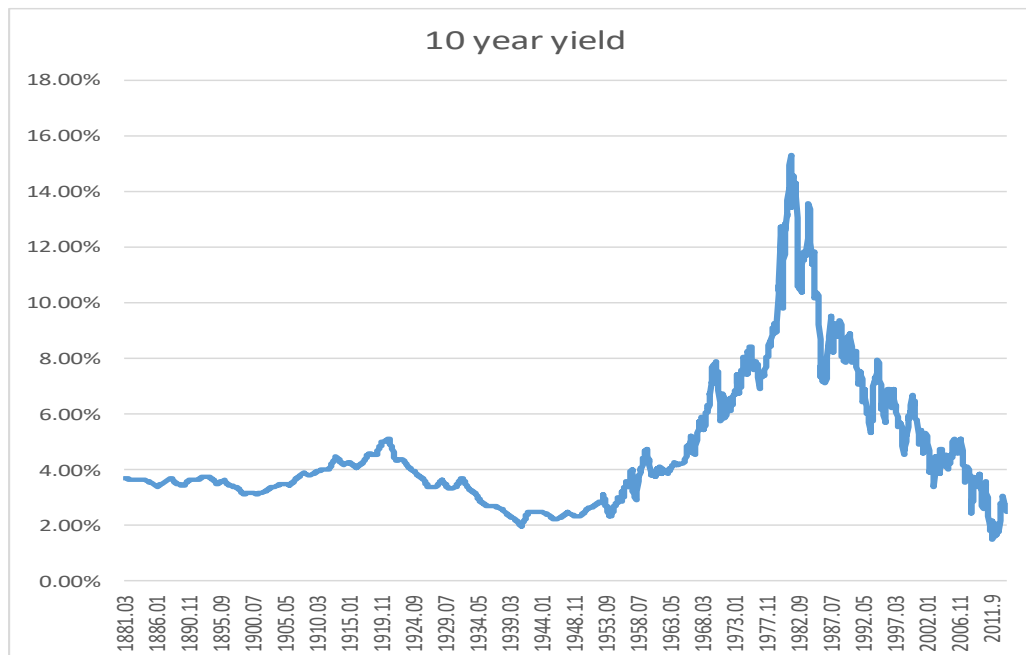
And the other negative data shown is the 2000-2002 Bear Market. Despite the Fed putting the breaks on their tightening, the Internet Bubble and War on Terror still pulled the market lower.

But, nevertheless, the average response by the market to a cessation in interest rate hikes is very positive.

## Our Current Market

Now that we have reviewed what the historical market precedents are for rising interest rate environments, we must now apply that knowledge to our current market place in order to derive some value from our research.

In our current environment, we have historically low interest rates. See the chart below of the 10 Year Treasury.



Data provided by the MRP Capital Investments, LLC database

We also have a Fed that has stated, as recently as their last Minutes, that even if economic conditions yield inflation over 2% and unemployment below 6.5%, they still may keep rates extraordinarily low.

Furthermore, Fed officials are on record as stating that interest rates should remain low until “late 2015.”

Putting two and two together tells me that the fear of rapidly rising interest rates is invalid. The Fed seems to be making it crystal clear that it will not kill this economic and stock market rebound by hiking rates too soon and/or too aggressively. And in keeping with the theme of this report, “Don’t Fight the Fed”, we need to know **what has that meant to the markets and the economy and what should that mean for the future of the markets and the economy?**

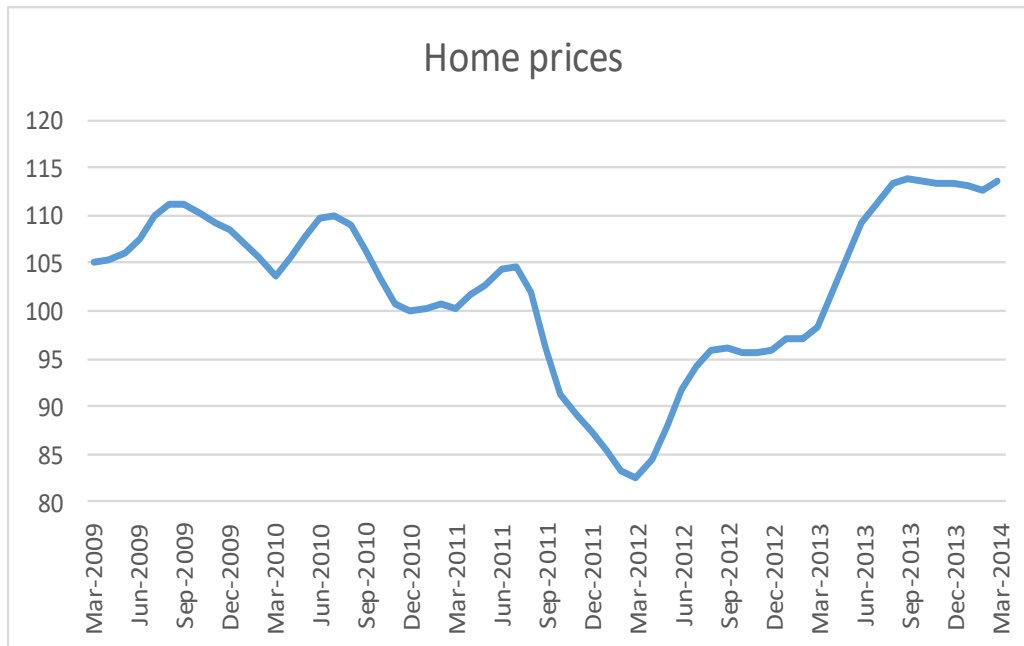
Since the Fed cut rates to extraordinarily low levels the stock market , as discussed earlier, is up about 189%.



S&P 500 3/6/2009 — 6/2/2014

Chart supplied by Bigcharts.com

The housing market has showed gains as well. With the entire national average being up 8.2% since March of 2009. But recently the index has shown excellent gains, registering a gain of 37.7% since March of 2012.



Home prices from 3/1/2009 — 3/1/2014

Data provided by the Case-Shiller National Price Index

With that data, it is clear that the Fed's actions have had a positive impact on market prices. But have the Fed's actions had a positive impact on the economy? Let's see...



GDP bottomed out in the 2nd quarter of 2009, with a reading of \$14.342 trillion. The latest reading of U.S. Gross Domestic Product, the 1st quarter of 2014, was \$17.101 trillion. In all, that represents a gain of \$2.759 trillion, or 19.2%. That is very solid, if not great, growth in my book.

Furthermore, the year-end unemployment rate peaked with a 2010 reading of 9.6%. The April 2014 data shows the unemployment figure being 6.3%. This represents a 34.3% decline in the unemployment rate, which is VERY significant. However, there seems to be a very large contingent of people who “pooh-pooh” this figure and cite the growing number of people that are not in the labor force. Yes, that is true. And that figure has been steadily growing since 1943 (which is the first year the Bureau of Labor Statistics has in their database). So, is this a recent phenomena or a trend that has always been with us? It seems to be the latter to me and should be inherent in a prosperous society where people can retire and live off their savings.

But, for those who don’t believe that, let’s throw out the unemployment rate and simply look at the number of people working, or the “Civilian Labor Force.” The following is a table of the “Civilian Labor Force”, with the data provided by the Bureau of Labor Statistics.

<u>Year</u>	<u>Civilian Labor Force</u>
2008	145,362
2009	139,877
2010	139,064
2011	139,869
2012	142,469
2013	143,929
Apr-14	145,669

#s in thousands

Our recovery, seemingly aided by the Fed and its actions, has now amassed a civilian workforce that is bigger than it was in 2008 and closing in on the biggest labor force ever. To me, this is further evidence that fighting the Fed is a losing game.

## Our Game Plan

The question becomes, “With these facts, what do we do now?” To answer that question, let’s play a little game.

First off, let’s take Chicago Federal Reserve Chairman Evans at his word that rates should stay low until “late 2015.” Let’s say “late” means October 1st.

So, in our game the Fed will begin an interest rate tightening cycle on October 1st, 2015. We know from the work done on the previous pages that the odds favor a stagnant to declining market during the first 3 to 6 months of any tightening cycle and a sluggish market approximately 1 year following the first rate hike. Given this, we need to have portfolios braced and ready for this occurrence no later than October 1st.

Furthermore, we know that once the tightening cycle ends the odds are with us that the market should appreciate significantly. So, we need to have our portfolios set up to take advantage of that growth at that time.

But, wait!!!!

**What happens in the markets prior to interest rate hikes?** What happens, say, 3 months prior to the hikes beginning? 6 months? A year? Well, let’s take a look.



Quite frankly, this data is staggering and compelling. To get a grasp on all the data and the averages, I've included the table below. It details the start of each Fed tightening cycle, starting with the 1971 cycle, and it shows the average price change in the S&P 500 over specific periods of time preceding the hikes.

<b>S&amp;P 500 price change from specified time frame until beginning rate hike cycle</b>	<b><u>3 months prior</u></b>	<b><u>6 months prior</u></b>	<b><u>1 year prior</u></b>
	3.91%	8.61%	15.01%

As you can see, the market, on average, shows significant appreciation heading into a Fed tightening cycle. In fact, if you look at the entirety of the cycles and the market movements, there has been an 87.5% chance of gains in the market 3 months prior to a tightening cycle, a 75% chance of gains 6 months out, and an 87.5% chance of gains 1 year prior to the Fed hiking rates.

This data tells me that our current market environment has a very good chance of registering some fairly significant gains prior to the Fed beginning its next tightening cycle. IF the Fed were to, indeed, begin to raise rates in October of 2015 and our market's appreciation was only average, we could see that S&P 500 come close to the 2,200 level.

With this, it appears that a prudent game plan has to include aligning portfolios to capture as much of this upside as is appropriate given each investor's individual Investment Policy Statements. While simultaneously being on the look out for when the Fed might begin its tightening cycle and being at the ready to adjust portfolio allocations and investments as necessary.

Why? It appears investors shouldn't try to fight the Fed.



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