Zacks INVESTMENT MANAGEMENT

Market Insights by Mitch Zacks

Will the Fed Rate Increase Hurt Stocks?

By Mitch Zacks
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The Federal Reserve (Fed) is poised to enter a cycle of raising interest rates this September, and market anxiety is palpable. Every new set of Fed minutes are met with increasing scrutiny — will they start hiking rates in September? Or, will it be December? Since the economy's expansion is already weak(ish), will this be the straw that breaks the camel's back? Are stocks doomed?

The Fed will likely initiate the first rate hike in September, yet that won't stop the economy from growing. I'm expecting the economy to soon transition into, roughly, a year-long period of 3% growth and stocks to post mid-single digit growth for the remainder 2015. In other words, there's little reason to get "defensive" with your portfolio. I don't see anything close to resembling doomsday—just business as usual.

Here are four reasons why.

1. The Market Already Knows – Fed rate hike timing has been one of the most widely discussed economic topics in the last two or three years, and at no point has Janet Yellen dealt us a shocking shift in her thinking for policy setting. The Fed is more transparent than ever—providing market guidance for interest rate policy and, as such, plenty of information to price-in the effect of rate hikes. A good rule of thumb with investing is— *if everyone is talking about a hot topic, it probably won't have much impact.*

2. Stocks Have Done Well During Rate Hike Cycles – if you look back at the last three stretches of Fed interest rate increases, stocks actually performed quite well: It makes sense why the market would do well during tightening cycles – the Fed typically raises rates when the economy has underlying health and strength, which means growth is good and corporations are in a position to expand earnings. All positive forces for stocks.

S&P 500 Performance		
During Past Interest Rate Increase Cycles		
Date Range of Hikes	Number of Rate Hikes	Annualized S&P 500 Performance
1994-1995	7	18%
1999-2000	6	5%
2004-2006	17	16%

3. The Pace of Rate Hikes Should be Gradual – Janet Yellen was spot-on in a recent comment she made at a Fed meeting calling out analysts and pundits for focusing on the wrong thing: "what should matter to market participants is the entire expected trajectory of policy." While the media is making a fuss over when the first hike will occur, more importantly is how gradually the rate hikes will happen. Slow and gradual increases, spread out over years, gives the market and economy time to adjust.

4. Earnings and Global Economic Growth Should Continue – strip away the negative stories of a Greek exit from the euro zone, China's wildly volatile stock market and 'implications' of Fed rate hikes and you'll find a global economy set to expand at a consistent—if not slightly better— pace than last year. Europe is hitting stride as they implement their own version of "quantitative easing," China is still set to grow 7% on year and we see the U.S. expanding a very acceptable 3% in the next year. Economic growth typically bodes well for earnings growth, and stocks should respond in kind.

The Bottom Line for Investors

There is one thing I'll concede as we enter a period of Fed 'tightening'— the era of rapid multiple growth in this bull market is likely behind us. From here, I think the market will move more in tandem with earnings, which may mean mid-single digit growth in the year or two ahead. That doesn't mean it's time to look elsewhere for returns. And, I certainly don't think you should shift strategy on account of a Fed decision to hike interest rates gradually from here. Compared to yields on fixed income and cash, stocks still look very attractive for investors seeking long-term growth.

-Best Regards, and Better Returns!
Mitch

About Mitch Zacks

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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