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Fed funds rate – a threat to the equity markets?

Peter Szopo

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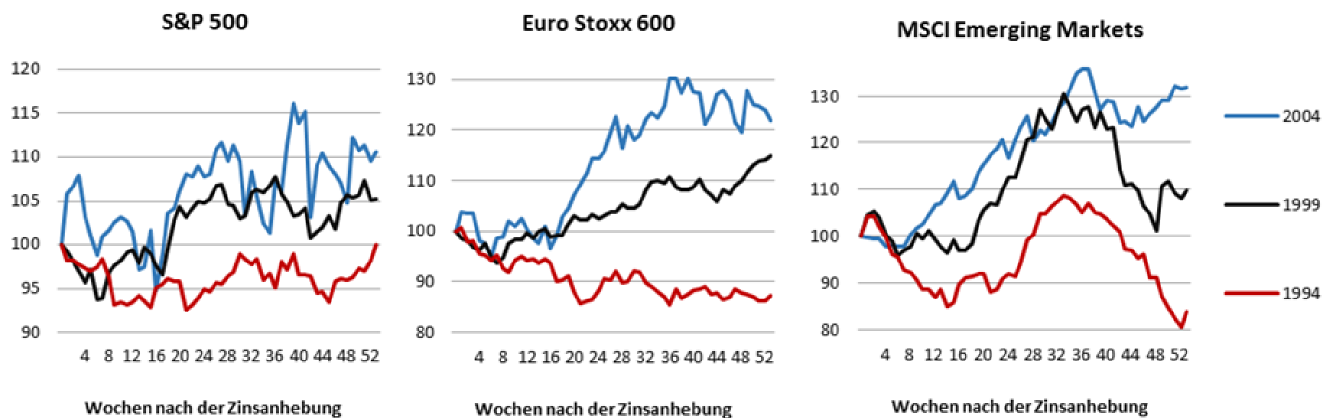
The US central bank, the Fed, is very likely – almost 90%, according to Fed funds futures – to raise the Fed funds rate this year. The expected rate hike has been one of the dominating topics on the financial markets for a year. The bursting of a mega bubble, rising pressure on fragile emerging markets, and the end of years of a share market rally in the USA are the most commonly mentioned worries in this context. None of which is overly far fetched, as we have indeed seen all of these scenarios before. Still – history prompts the conclusion that there is no need to panic, at least not when it comes to equities.

Effects differ every time

In the past 25 years we have seen three comparable phases, where the Fed increased the Fed funds rate after a longer period of low interest rates and set off a new interest rate cycle: 1994, 1999, and 2004. Although the results were different every time, they were never disastrous. While the equity markets did almost always come under pressure immediately after the rate hike, they also experienced a recovery about four months after the Fed funds hike. After the hikes in 1999 and 2004, the S&P 500, the Euro Stoxx 600, and the MSCI Emerging Markets index had already clearly exceeded their respective levels prior to the interest rate hike by the Fed (by up to 30%) within six to nine months. Only in 1994/95, when the Fed funds rate was increased by three percentage points to 6% within twelve months, European and emerging markets equities lost significantly, and the subsequent recovery took longer.



Sources: Bloomberg; own calculations

Surprise effect should play a subdued role

A number of arguments suggest that the equity markets should be reacting less noticeably to the interest rate reversal. Firstly, there has probably never been a monetary measure that was discussed in more depth and in public than this interest rate increase. The surprise effect should be very limited. Secondly, in spite of the recovery since last year the US economy is still weaker than at the beginning of previous interest rate cycles. Inflation remains non-existent. We therefore expect moderate increases and a flatter upward path than at previous occasions. Thirdly, the US interest rates will be increased around a time when the ECB and the Japanese central bank are sticking to their monetary loosening for domestic reasons, and the Chinese central bank may soon follow that stance. And lastly, with regard to the emerging markets – while there are a few weak economies such as South Africa and Turkey, overall the block of emerging markets is in better shape than it was at the middle of the 1990s.

Elevated volatility expected

For equity investors, the expected rate hike by the Fed means that elevated volatility and short-term pressure are to be expected. There might be trading opportunities (which at hindsight will of course have been crystal-clear), but the empirical evidence does not suggest that the interest rate policy of the Fed would trigger a change in strategy among equity investors with a long-term horizon.

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