

Interest Rates and the Stock Market

We thought that it might be constructive to reflect on recent interest rate hikes by the Federal Reserve Board and how those actions have impacted the stock market. We have now had 15 consecutive rate hikes beginning on June 30, 2004 that have brought the federal funds rate (the overnight lending rate between member banks) from 1.00% to 4.75%. Recent comments from FED officials as well as strong economic data suggests that the new chairman, Ben Bernanke, may well orchestrate additional hikes bringing rates to over 5%. Wherever short-term rates end up, it is reasonable to assume that the vast majority of the hikes are behind us and the end is in sight.

There is an old Wall Street adage that says you can't fight the FED. The gist is that gains in the stock market are hard to come by when interest rates are rising. Indeed, the Standard & Poor's 500 Index has risen from 1141 when rate hikes started in the summer of 2004 to the present level of approximately 1295, a modest gain of about 13.5% over a 20-month period. There is near unanimous agreement among investors that the gain has been bruising at best, marked by volatility and outsize gains in one sector, energy, due to sharply higher oil prices. History has also shown that periods of flat or declining interest rates are more favorable to stock prices, and this brings us to another old Wall Street saw.

It has often been said, "nobody rings a bell at market tops or bottoms". Oh, if only it were so easy that a clear signal told investors when to buy and sell stocks. What we do know is that the stock market typically anticipates the future, and unless this time is different, a dangerous assumption at best, better times for stocks lie ahead as rate hikes come to an end. In the absence of a bell that gives the all clear signal, we believe that the prudent course for investors is to stay fully invested in quality equities that offer potential for capital gains and income through dividends. History also shows that market timing is a tricky business at best, as often the biggest gains come in the early stage of an advance.

The discussion on interest rates would not be complete without some commentary on longer dated maturities of 5 years and greater. At this writing the difference in yield between the 6-month Treasury bill and the 30-year T-bond is 15 basis points, or 0.15%. Typically, the actions of the FED affect only short-term rates with longer-term rates being determined by investor perception of future inflation. The yield curve (or lack thereof) suggests that inflation will remain contained in the near future. Low long-term interest rates can also be attributed to several factors that have dramatically increased foreign purchase of US treasuries. Our large trade deficit has resulted in our trading partners holding greenbacks that they have to do something with, and petrol dollars held by oil exporters have found their way to the US market.

Here is the first quarter scoreboard:

Dow Jones	+3.66%
NASDAQ:	+6.10%
S&P 500:	+3.73%

Bill Novelline

Andrew Novelline

Bob McLemore

April 10, 2006