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What Happens When the Fed Raises Rates?

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As we approach the upcoming FOMC meeting, investors are busy making decisions based on the expected rate hike. How much will the Fed raise rates? Should you buy? Should you sell? Should you do nothing?

To answer those questions, Eunoia Financial has examined past rate hikes and the subsequent effect on market returns.

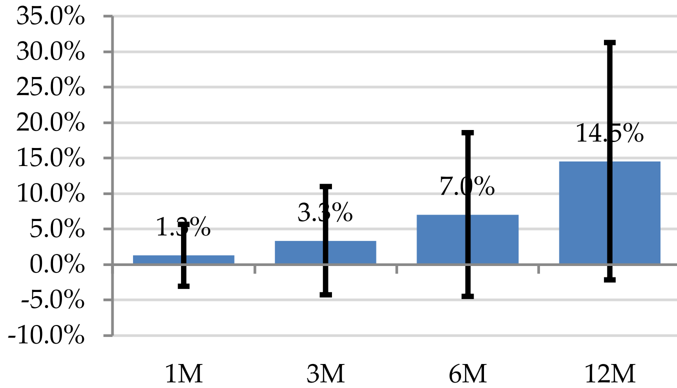
Based on the CME Group 30-Day Fed Funds future prices, investors are anticipating a 0.25% rate hike on December 16th. The odds of a hike currently stand at 83%. Check here to see updates for this, or future, rate changes.

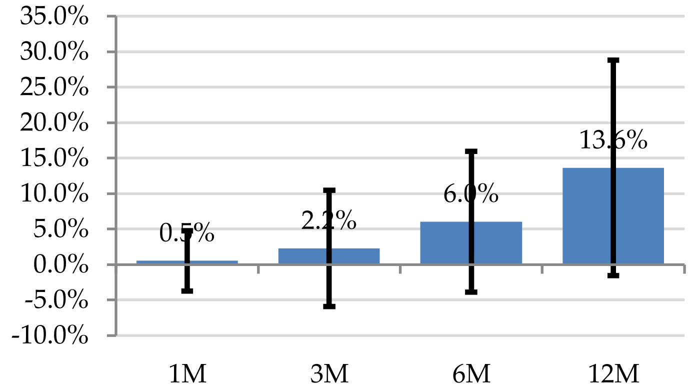
Using the Wilshire 5000 as a proxy for the broad market, we can see the following:

- If past returns are indicative of future expectations, investors can expect positive returns from a broad equity investment. Yearly returns have averaged 14.5% since 1982.
- However, those returns come with volatility, +/- 17% on average. Meaning, investors can have reasonable expectations for their portfolios to gain roughly 30% or lose 2% in any given year – although we know there have been instances of much larger deviations (for the statisticians among us - market return distributions have fat tails).

Assuming that the Fed will in fact raise rates as expected, the question turns to what happens then?

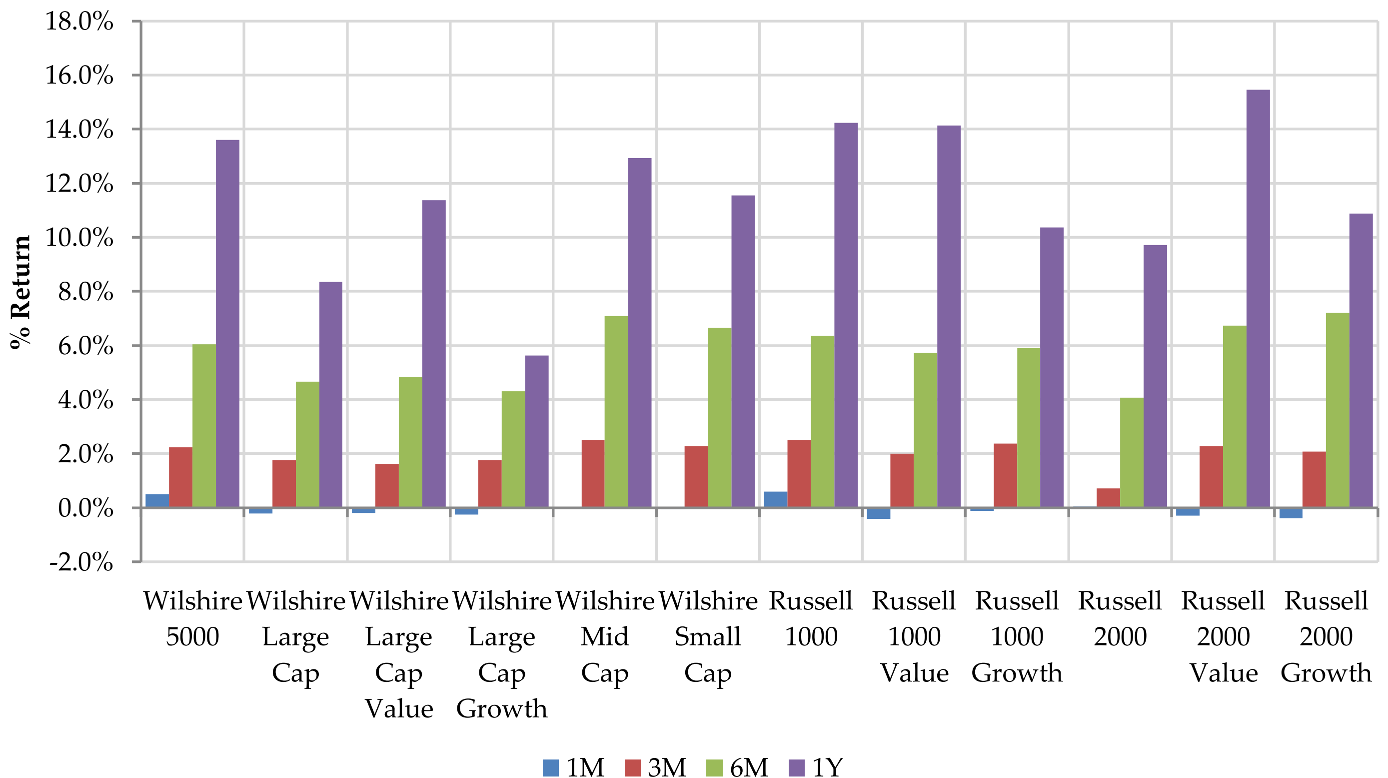
- In the first month after a rate hike, the market gains less than usual, but it still rises. The volatility of that gain is approximately equal to all periods.
- After three months, the expected gain is lower than normal again… and the volatility rises slightly. Meaning, we have less confidence in our returns and more downside risk over three months.
- In six months, investor's expectations after a rate hike again are lower than usual.
- Over the course of a full year, investors can anticipate an average return of 13.5%, while normal markets return 14.5%.





These are not huge differences and not overly worrying, but what about other sectors? From the below we can see that there is safety in size and value.

- Large cap returns are greater than small cap. Comparing the most non-overlapping indices, the Russell 1000 outperforms the Russell 2000 in all time periods except one month.
- Over longer time frames, value returns are greater than those of their growth counterpart.

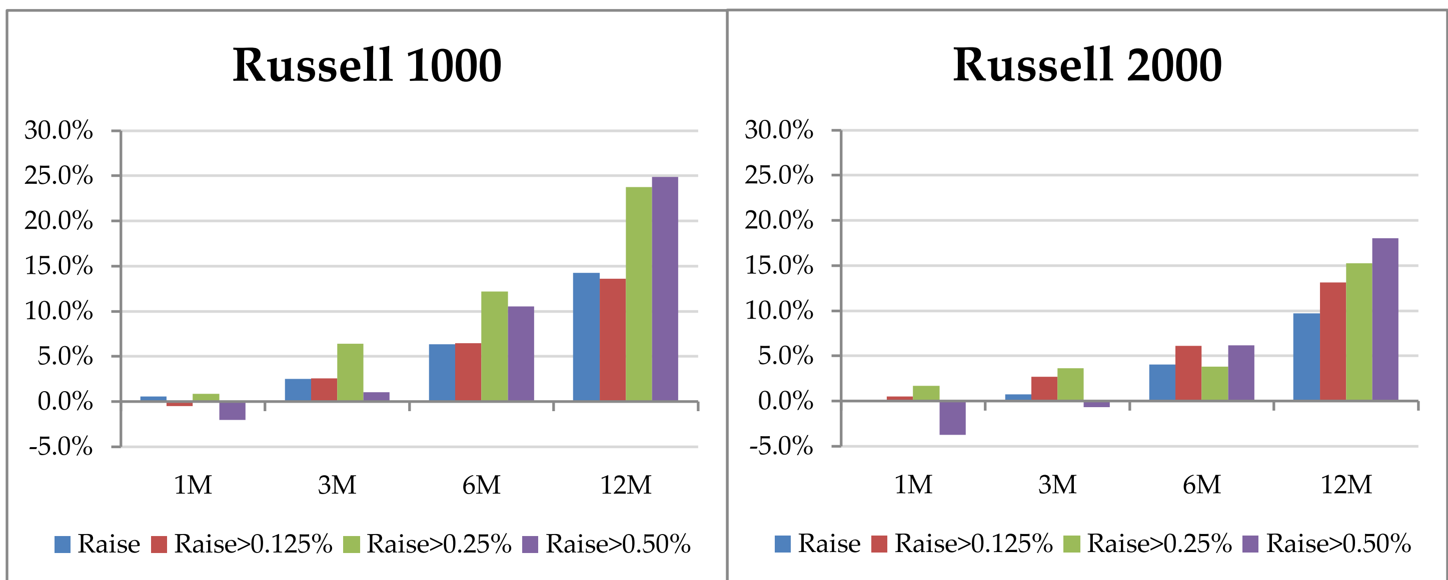


Conclusion

Safety is the name of the game when the Fed raises rates. Avoid speculative and/or small cap stocks in your portfolio around Fed rate hikes if at all possible. If you have new cash to invest, perhaps wait a bit to see how the market plays out in the short-term. Most importantly, never panic.

Before we finish, there's one more question to answer; should investors take different action depending on the size of the rate hike? While the futures market tells us to expect a 0.25% increase, we should always be prepared for every scenario.

Based on the below charts, with the exception of a large hike (0.5% or more) over the first three months, the data doesn't seem to indicate a change of plan based on the size of the hike. It's more likely the case that the 0.5% rate hikes were unexpected (at least by some portion of market participants) and the market's reaction reflects their surprise. Once investors adjust to the surprise, even large rate hikes are not disasterous for investors.



The Federal Reserve Act (that which governs the Federal Reserve) states the Fed's job as:

> "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."

In other words, the Fed has dual mandates – promote growth and control inflation. While these mandates are at least partially conflicting, the actions taken by the Fed are designed to satisfy both. By taking this action

now, the Fed clearly believes long-term growth will not be hampered by an increase in interest rates while it also clearly believes that interest rates must rise to maintain a stable price environment.

Super Conclusion

Many will argue with the motives of the Fed, but whether you agree or disagree, the past does not suggest rising rates to be problematic for long-term investors.