Weekly Market Commentary

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Ready, Set, HIKE!

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Highlights

The first rate hike by the Fed has never been an indication of a market peak.

On average, the first rate hike has taken place 37% into the economic cycle (measured peak to peak).

The S&P 500 has returned on average, another 58% after the first rate hike (price return) before the market peak for the economic cycle.

The initial market reaction to a rate hike is, on average, negative, but the data show it pays to be invested.

In only 10 days, the NFL regular season begins. Teams and coaches will be analyzing each other's moves and plays, looking for any indication that can give them an edge to succeed. Some will play strong offense, others good defense from the moment of the first kickoff. Although some big plays could happen during the first kickoff or first hike, we know this is only the start of the game, and in turn only the start of the season. History suggests the same is true for the first Federal Reserve (Fed) interest rate hike as it relates to the stock market and economy.

While football teams are looking for an edge against their opponents on the field, investors will be keeping a close eye on the Fed to try and gain an edge as to when it will finish winding down its bond-buying program (quantitative easing 3) and eventually begin hiking short-term interest rates.

Investors appear to be comfortable with the end of quantitative easing following last year's taper tantrum; however, the new fear is what impact Fed rate hikes will have on the market. Improving economic growth, as well as a lower unemployment rate and inflation moving closer toward the Fed's target, has been supportive of higher stock market levels and valuations, as we see the S&P 500 Index continue to make new highs. Corporate revenue and earnings growth have also been supportive of the stock market's hike higher. But when Chair Janet Yellen, as the Fed's new quarterback, announces the first rate hike either to cool the economy or to curb inflation, what impact will we see in the market and economy? Will it be better to go on the offense or play good defense? We take a look back in this *Weekly Market Commentary* to provide evidence as to why we believe it is still time to play offense.

The first rate hike by the Fed has never been an indication of a market peak.

Looking at data going back to the 1950s, we see that following a recession, the first rate hike by the Fed has never been an indication of a market peak [Figure 1]. This should make sense, as the Fed typically begins to hike rates or tighten only when it starts to see growth improving or the economy getting too "hot," as measured by inflationary pressures.

From an economic standpoint, as indicated by Figure 2, on average the first rate hike has taken place about 37%, or less than halfway into the economic cycle (measured peak to peak). This would only put us near our own 40-yard line. (While worth noting, this is only one data point.)

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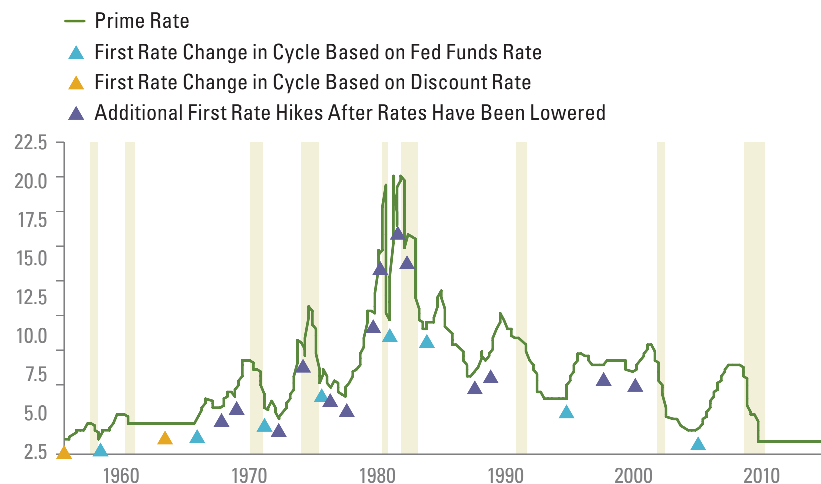
Peak to peak indicates the peak of economic activity in the prior cycle to the peak of economic activity in the current cycle. For example, in the prior downturn, November 2001 was the peak, and the next peak was December 2007.

1 The Bank Prime Loan Rate Tracks Federal Reserve Fed Funds Rate Policy



Source: LPL Financial Research, Federal Reserve 8/22/14

Shaded areas indicate recession.

2 First Rate Hike Is Typically About Halfway Into Economic Cycle

First Rate Hike	% Cycle Complete at First Rate Hike	S&P 500 Move From Hike to High
4/15/1955	44%	31%
9/11/1958	42%	25%
7/1/1963	34%	20%
4/23/1971	35%	16%
7/18/1975	28%	19%
8/22/1980	43%	12%
8/8/1983	23%	131%
3/24/1994	35%	229%
6/30/2004	49%	37%
Average	37%	58%

Source: LPL Financial Research, Bloomberg 8/22/14

The S&P 500 has returned on average, another 58% after the first rate hike (price return) before the market peak for the economic cycle. The first rate hike has not marked a top in any of the prior nine economic cycles, with the S&P 500 advancing from a low of another 12% to a high of another 229%, leaving us relatively optimistic, given recent economic data and a strong earnings season, that a rate hike will provide us more opportunity to play offense before the final whistle blows for the current expansion.

Stock market performance is really the name of the game and can be viewed through several different angles. The near-term view, as measured by one, two, three, and four quarters after the first rate hike, suggests that while there are some negative periods, on average returns are positive [Figure 3].

3 One Year After the First Rate Hike, Stocks Are Up on Average 7%

Quarters After Rate Hike	T + 3 Mos	Annualized	T + 6 Mos	Annualized	T + 9 Mos	Annualized	T + 12 Mos
Average	1.61%	6.43%	2.28%	4.57%	3.84%	5.12%	7.00%
Median	-2.30%		1.06%		3.56%		4.43%
Max	11.70%		15.85%		17.70%		26.34%
Min	-4.91%		-8.60%		-15.05%		-10.76%
Rate Hikes Following Recessions	9		9		9		9

Source: LPL Financial Research, Bloomberg 8/22/14

Calculations are based on price only.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. One cannot invest directly in an index.

T represents day of initial rate hike following a recession.

The Fed sometimes lowers and re-raises rates prior to the end of a recession to tweak policy, address economic weakness that does not develop into a recession, or in response to an initial rate hike that occurred too soon. Since this is a relatively small sample, we looked back at all scenarios when the Fed raised rates for the first time after rates had been lowered. Keep in mind, there were different reasons for some of these specific rate hikes that may not be as relevant to the current environment.

We also included a one-month forward look to see how equity markets responded in the very short term. As Figure 4 illustrates, on average the S&P 500 was flat one month and three months following an initial rate hike, but its pace over the rest of the year was in line with its historical average. The initial market reaction to a rate hike is, on average, negative, but the data show it may be a good time to be invested. Like losing a few yards on first down, the market reaction over the first one to three months is slightly negative. However, over longer-term periods of six months or more, the stock market has averaged gains following the Fed's first interest rate hike and shows how it could pay to remain invested despite the possibility of Fed rate increases.

4 Stock Market Not Adversely Affected by Initial Rate Hike

S&P 500 Index Subsequent Absolute Price Performance

	T + 1 Mo	T + 3 Mos	T + 6 Mos	T + 9 Mos	T + 12 Mos
Average	-0.78%	0.02%	1.38%	2.63%	5.80%
Median	-1.75%	-0.86%	2.64%	3.56%	4.43%
Max	7.09%	11.79%	19.57%	21.34%	39.25%
Min	-10.02%	-9.85%	-27.89%	-32.19%	-16.29%
Initial Rate Hikes	25	25	25	25	25

Source: LPL Financial Research, Bloomberg 8/22/14

Calculations are based on price only.

T represents day of initial rate hike.

Consistent with our message in our *Mid-Year Outlook 2014*, we believe we are only roughly halfway through the current economic cycle, leaving more room for the economy to grow, the stock market to reach more new highs, and investors to play more offense as the Fed is only nearing the very early quarters of a tightening cycle to end the game. ■

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Stock investing involves risk including loss of principal.

INDEX DESCRIPTIONS

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