Weekly Commentary May 20, 2016

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Fed Roils the Markets but Equity Investors Shouldn't Fear

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The Fed surprised the markets this week with strong hints that it will hike the Funds target in the June meeting. I stated last week that if the Fed was going to hike, it had better start making noises now because the markets were getting lulled into thinking the next hike was months away. Although the July funds contract is selling at 45bps, which indicates only a 1 in 3 chance of a hike, I have noted that this probability is biased downward due to the contract being a negative beta asset. I believe the true chances of a rate hike are now around 70%. To be sure, we have one more payroll report and several inflation reports before the June meeting, but the April minutes clearly stated that is the economy improves, as the Fed expects, most members favored a rate hike. And current estimates of Q2 GDP growth are between 2% and 2.5%, a substantial improvement from the 0.5% growth reported for Q1, which is now expected to be revised upward to nearly 1%.

There is a positive side for equity holders to the pending rate hike: The Fed believes the economy is strong enough to continue the normalization of monetary policy, something that stock investors should cheer. Certainly if we get a spate of negative economic reports over the next four weeks the Fed will defer, but I don't believe that Fed will delay the hike because of the UK "Brexit" vote that occurs ten days later. The Fed doesn't not consider a UK exit, which looks increasingly unlikely, to be of the magnitude of the turmoil we saw in the global markets last February when the commodity markets collapsed and China appeared on the brink of a massive devaluation. The global markets have clearly stabilized and oil prices have remained very firm. Whether the Fed tightens again in its September meeting is a closer judgment with the US presidential election coming two months later, but it is way too early to make that call now.

As far as equities are concerned, it is very rare for the bull market to end on the first, or even the second rate hike. After the 2001-202 recession, the Fed began raising the funds rate in July 2004, but stocks continued to rise for another 27 months. After the 1990-91 recession the Fed began to hike rates in early February 2004. After a brief pause we witnessed the start of one of the strongest bull markets in stocks in history. In my opinion, stock investors are far more concerned about a rebound of earnings, which is the likely outcome of a stronger economy, than about a 25 bp hike in the short rate.

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