November 10, 2014

Fed Rate Increases, the Emerging Markets and the Oddity of Post-Election Stock Market Cycles

During a conference in Paris last week, two Federal Reserve officials spoke of their concerns of an increase in market volatility next year due to rising interest rates. Both Janet Yellen, Federal Reserve Chairwoman, and William Dudley, New York Fed President, made statements along these lines.

Market volatility has risen over the last 2 years whenever Fed officials talk of raising interest rates. Then-Chairman, Ben Bernanke, spoke of the potential of raising interest rates in the summer of 2013. Immediately following his comments, global equity markets swooned, particularly the emerging markets whose currencies came under downward pressure. When Janet Yellen spoke of rising interest rates earlier this year, the markets took a temporary tumble.

In his comments, William Dudley singled out the emerging markets as an asset class that may see downward pricing pressure when the Fed starts to raise interest rates. We have been anticipating a raise in interest rates next year. When will this happen? We don't know, but we suspect the increase will occur in the 2nd half of the year. Do the world's capital markets swoon when the Fed starts to raise interest rates? What does history tell of us such events?

Stock Prices and Fed Interest Rate Increases

We turn to Ned Davis Research with the question of the stock market's reaction to past interest rate increases. Since 1930, the Fed has initiated initial interest rate increases on 19 occasions. Average returns for the S&P 500 *following* the initial Fed rate increase are shown below.

Number of Trading Days Following Rate Increase			
	63	**126**	**252**
Average S&P 500 Return Following Rate Hike	-1.6%	5.8%	7.0%

As you can see, the U.S. stock market has been somewhat choppy after the initial interest rate increase. However, the market has tended to find its footing fairly quickly. One year following the initial rate increase, the market has been higher by 7%, on average. Some would ask why the market has been rather impervious to initial Fed rate increases. The answer lies in the underlying fundamentals that normally accompany a Fed rate increase. Normally, the Fed has not initiated a cycle of rate increases unless the economy is growing rapidly and is possibly accompanied by rising inflationary pressure. In a world where *deflation* pressures are among the most concerning, a slight upward push in economic growth and inflation would be welcomed news for many.

Emerging Markets and Fed Rate Increases

The emerging economies are cash hungry. With young population bases and more rapid growth than larger, developed countries, many emerging economies need capital inflows to finance their rapid growth rates. If the Federal Reserve is raising interest rates, capital will tend to flow ***towards the U.S. and the dollar may appreciate in value in relation to many foreign currencies. Investor preference should lean towards dollar based assets as currency markets would favor the U.S. dollar.*** This is a risk which may unfold next year for the emerging stock markets.

Measuring the Risks

Is this risk higher or lower than in past Fed tightening cycles? Governments sell their debt to both domestic and foreign investors. As stated earlier, emerging economies have needed financing from foreign investors to fund growth. However, due to wealth generation and productivity gains in the emerging economies, this picture has been changing.

Comparing countries' needs for capital from outside investors in these cases is useful. The amount of foreign ownership of a country's debt as compared to the size of that economy (external debt ownership/GDP) gives us a sense of the relative risk one country may face relative to another when investor preferences shift. ***The amount of emerging economy debt foreign investors own represents 32% of GDP in the emerging markets.*** What is this ratio for the developed countries? An average of ***the foreign investor owned debt is equivalent to 182% of GDP for the five largest developed countries***. Measured in this fashion, emerging economies are much less dependent on foreign ownership of their sovereign debt than developed countries.

Countries with large external financing needs may indeed face rather severe pressure when the Fed starts to raise rates. However, on average, emerging economies' needs for external financing has declined by more than 20%, from an annual level of $510 billion in 2010 to less than $400 billion today. While external financing needs are now lower than a number of years ago, the need is still present, as is the risk to asset values due to a rise in Fed interest rates.

Time to Sell Emerging Markets?

The quick answer to this question, in my opinion, is no. Am I concerned about a Fed rate increase and the resulting effect on emerging stock markets? Yes, I am. However, we need to consider three factors which, as a whole, mitigate some of the potential shorter-term risk these markets face due to a rise in Fed interest rates.

1. **Timing and level of rate increase**. When will the Fed start to raise interest rates? Nobody knows – although, most believe the initial rate increase will occur in the 2nd half of next year. That is a long way off. This gives Fed officials time to prepare market participants for the rate increase. The market's reaction to a rate increase would be stronger if a surprise rate increase were to take place. I don't believe Yellen and the rest of the Fed governors are big fans of surprising the markets – witness the comments

made last week by both Janet Yellen and William Dudley.

2. **Emerging market equity valuation levels**. Emerging markets, as a whole, are selling at very attractive valuation levels. For example, the emerging markets are selling at about 11x earnings, while the developed markets are selling at about 16x earnings. Based on 20-years of data, the emerging markets are selling at lower absolute valuation levels now than has been the case on average over the last 20 years. The same can't be said for many of the developed markets.

3. **Long-term growth rates within the emerging economies**. The average emerging economy is growing at a *multiple* of the growth rate present in the developed economies. Additionally, demographics and productivity growth rates favor the longer-term relative growth story of the emerging space as compared to the more mature developed economies. With economic growth comes corporate profit growth. With corporate profit growth comes stock price appreciation – normally.

Historical Post-Mid-Term Election Stock Market Oddity

As most know, I study economic and capital market historical trends. Trading activities within the financial markets never follow a script, but oddities based on the time of year and political events tend to rhyme with historical performance. As an example, the old saw - "Sell in May and Go Away" – suggests that more times than not, the period from May to the end of October tends to be negative for stock prices. In addition, the period from the beginning of November to the end of January tends to be a time of good performance for the stock market.

I thought I would do a little digging on this issue – to find out *how good it has been to own stocks, not only during the November – January period, but the November to January period following a mid-term election. Have mid-term elections had any impact on this calendar oddity?*

Just the Facts

Since 1949, there have been 17 mid-term elections – 16 of which we know how the stock market (as measured by the S&P 500 Index) performed in the November – January timeframe. I've done a lot of work on historical return patterns and trends and these results *are among the most powerful I've found in terms of consistency and positive return basis.*

On a price only (not including dividends) basis, the S&P 500 has, on average, generated a return of 9.13% over the 3-month period from November to the following January in the 16 mid-term election years. ***9.13%! That return isn't annualized – it is the average 3-month return***. A normal or average 3-month return is 1.9%.

What about consistency? Out of the 16 periods, 14 generated positive returns ***for a positive batting average of .875. Take that, Babe Ruth!*** The best single-period return was in 1962 when the S&P was up 17.1% from November-January. The worst single-period return was in 2002 when the market declined by 3.32%.

What is truly stunning is the average annualized rate of return for the 3-month periods under observation, in addition to the consistency of this pattern. If an investor had simply bought the S&P 500 (which is impossible, as an investor cannot invest directly in an index, but go with me for example's sake) on November 1st of each mid-term election year and sold on January 31st the year following the mid-term election, his total return would have been ***a whopping 295.7%.*** The ***average annualized return with this strategy would have been 41.04%.***

Like all good trends, there is logic behind why they occur. Historically, pension and profit sharing plans tend to fund their annual contribution during the November to December timeframe. Consequently, large institutional demand for various asset classes tends to rise towards the end of the year. In addition, many workers receive bonuses at the end of the year, which leads to increased investments during this period.

History may not repeat itself – but, this is one of the more powerful cycle oddities I have uncovered.

We will be back next week.

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