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WEEKEND INVESTOR

Fed Up: How Will Rising Interest Rates Affect Stocks?

By **JASON ZWEIG**
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Don't worry about the Fed; be happy.

That is the message from analysts and market strategists. The Federal Reserve signaled this past week that it is unlikely to raise short-term interest rates until at least June. And that rise, when it comes, will be a good thing, investment professionals are saying, since the Fed will raise interest rates only when it is confident that the economic recovery is robust and companies have regained the ability to raise prices.

Furthermore, investment firms point out, stocks have done well in past periods of rising interest rates, gaining an average of up to 8% or 10% annually, depending on the measurement period and how Fed policy is defined. The highest returns have tended to occur when rates have risen gradually from low levels during periods of negligible inflation, much like conditions today.

Perhaps all this helps explain why investors seemed mildly disappointed when the Fed reiterated on Wednesday that it would remain "patient." Some people seem to want to get the waiting over with so the period of rising interest rates—and presumably even higher returns—can begin.

Not so fast, say Robert Johnson, Gerald Jensen and Luis Garcia-Feijoo, authors of a new book, "Invest With the Fed," to be published in March by McGraw Hill.

Comparing the returns of U.S. stocks against a wide range of other financial assets and analyzing the Fed's actions on interest rates back to 1966, the three researchers find that stocks typically aren't devastated when rates rise. But on average, they show, U.S.

stocks barely keep pace with inflation during periods of tightening Fed policy—and, surprisingly, Treasury bonds outperform stocks during such periods.

Mr. Johnson is president of the American College of Financial Services in Bryn Mawr, Pa., which trains banking, insurance and investment professionals; Mr. Jensen is a professor of finance at Northern Illinois University in DeKalb, Ill.; and Mr. Garcia-Feijoo is a finance professor at Florida Atlantic University in Davie, Fla.

The researchers characterized periods as "expansive" (when the Fed lowers both the discount rate and the federal-funds rate, two of the tools it uses to set monetary policy), "indeterminate" (when both of those rates aren't moving in unison) or "restrictive" (when the Fed raises both). Each of those three conditions accounts for about a third of all the months between January 1966 through December 2013, so there is plenty of data to compare.

Over that full history, after inflation, the S&P 500 returned an annual average of 6%, including dividends.

In expansive periods, when the Fed was cutting rates, stocks did even better, gaining 12% annually.

During indeterminate periods, when the Fed was on the monetary fence, stocks returned an annual average of 7%.

But in restrictive periods, when the Fed was raising rates, stocks generated an annual average of only 0.8%.

Meanwhile, the researchers found, cash and 10-year Treasury notes returned an annual average of 0.9% and 3%, respectively, over the full period from 1966 through 2013. But when the Fed was raising rates, cash returned an annual average of 0.5% and bonds 1%. (All of the above returns are approximated after inflation.)

"It's not so much that bonds do well as that stocks do poorly," Mr. Jensen says. During past periods of rising rates, he explains, many investors have fled the greater uncertainty of stocks for the relative safety of Treasurys—causing bonds to perform less badly than stocks. Most investors, trained to believe that rising rates are bad for bonds, expect the opposite. Cash also tends to do relatively well while interest rates are going up.

Although bonds usually beat stocks when rates rise, they haven't always. The most

extreme exception: the period from 1979 through 1982, when then-Fed Chairman Paul Volcker was increasing rates to snuff out inflation. Stocks outperformed bonds by a wide margin during that time.

Of course, financial history never repeats itself exactly, although it does rhyme. And the Fed's monetary policy is just one of a multitude of factors that influence the stock market, so you would be foolish to base your investment decisions on that alone—especially because the central bank's predictions of what it will do don't always come to pass.

In December 1993, for example, the Fed's monetary committee said a rise in rates had become more likely "at some point but not necessarily in the very near term."

Only 45 days later, in response to surprisingly rapid economic growth, the Fed began jacking up rates. In 1994, stocks gained 1.3%, cash returned 4%, and 10-year Treasurys lost 8%.

Considering that U.S. stocks aren't far below their all-time peak prices and are selling for a historically high multiple of profits, the past effects of rising rates are another reason for investors to be cautious. Differences in future returns depend mainly on how cheap stocks are in the present. So a rise in interest rates, if it took stocks down a peg, could be welcome for long-term investors.

"None of this means you should bail out of the stock market," Mr. Johnson says. "But people should condition their expectations and temper their enthusiasm."

—intelligentinvestor@wsj.com; twitter.com/jasonzweigwsj

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