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Take Away The Punch Bowl, Small-Cap Stocks May Keep Drinking

Interest Rate Hikes And Small Cap Stock Returns

Investor attention has focused on the Federal Reserve's actions following a relatively chaotic few months in the bond market. Chairman Bernanke recently suggested that the Fed would perhaps begin tapering its purchases of bonds, and that bond buying could be completely over by the middle of 2014. The Fed talking seriously about tapering has many investors considering the logical next phase – albeit far down the road – of an eventual new era of Fed tightening.

While exact dates and periods of past tapering actions or interpretations of "Fed speak" can't be measured precisely, we can take a look at past periods of interest rates hikes and their effect on small cap equities. From this data, investors may gain some historical context to enhance their perspective regarding future Fed actions and market returns.

The previous six times the Fed embarked on a tightening cycle and the associated small cap returns are below:

During each of the last six instances, small cap returns have provided positive average returns over the 3-, 6-,12-and 18-month periods following Fed tightening

RUSSELL 2000 INDEX RETURNS FOLLOWING FED FUNDS RATE INCREASE

Hike Date	3 months after	6 months after	12 months after	18 months after
8/7/80	13.9%	12.7%	27.0%	13.0%
2/1/83	16.6%	27.8%	17.6%	3.3%
10/1/86	-0.5%	22.9%	28.9%	7.3%
2/4/94	-2.6%	-5.4%	-2.7%	16.5%
6/30/99	-8.3%	6.4%	13.4%	3.8%
6/30/04	-4.1%	9.5%	9.4%	16.4%
Averages	2.5%	12.3%	15.6%	10.0%

During each of the last six instances, small cap returns have provided positive average returns over the 3-, 6-, 12- and 18-month periods following Fed tightening. Notably, small cap stocks generally performed very strongly for the first twelve months following a rate hike, followed by a pull back during the ensuing six month period. This indicates that, historically, if there is a time for concern regarding small cap returns in relation to Fed actions, that time is typically twelve months following a rate hike.

It makes sense that small cap stock prices would rise following a rate hike if you consider the natural business cycle. Stock prices anticipate economic growth at the beginning of a cycle, followed first by economic improvements and then Fed rate hikes as a last response. When the Fed finally gets around to "removing the punch bowl," it is likely that economic growth is well underway and stock prices are continuing to rise in response.

We don't know exactly if the recent Fed tapering is a harbinger of future rate hikes, and if so how soon. The Fed has reaffirmed that tightening wouldn't begin in earnest until unemployment comes down, potentially as late as 2015. But if and when we do begin to see Fed rate hikes, the stock market should in theory be higher because companies' corporate earnings will be higher. And as seen in the data, small cap stocks have historically continued to climb for up to one year following the date of the initial rate hike.

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