

Preparing for a Change in Federal Reserve Policy

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The Federal Funds rate for interbank, overnight borrowing has been in the 0.08% to 0.2% range throughout 2011. What do you think the stock market will do when the Federal Reserve decides to raise the target rate to, let's say, 0.5%?

Many respond to that question by predicting a drop of 2.0% to 3.0% in major market indexes. Based on the previous economic cycles, however, ICON does not share that concern. We believe instead that the market can continue its upward path for the next 24 to 36 months. Rising rates don't necessitate a market pullback, and even if irrational anxieties created short-term set-backs, ICON would view these losses as opportunities to increase equity exposure.

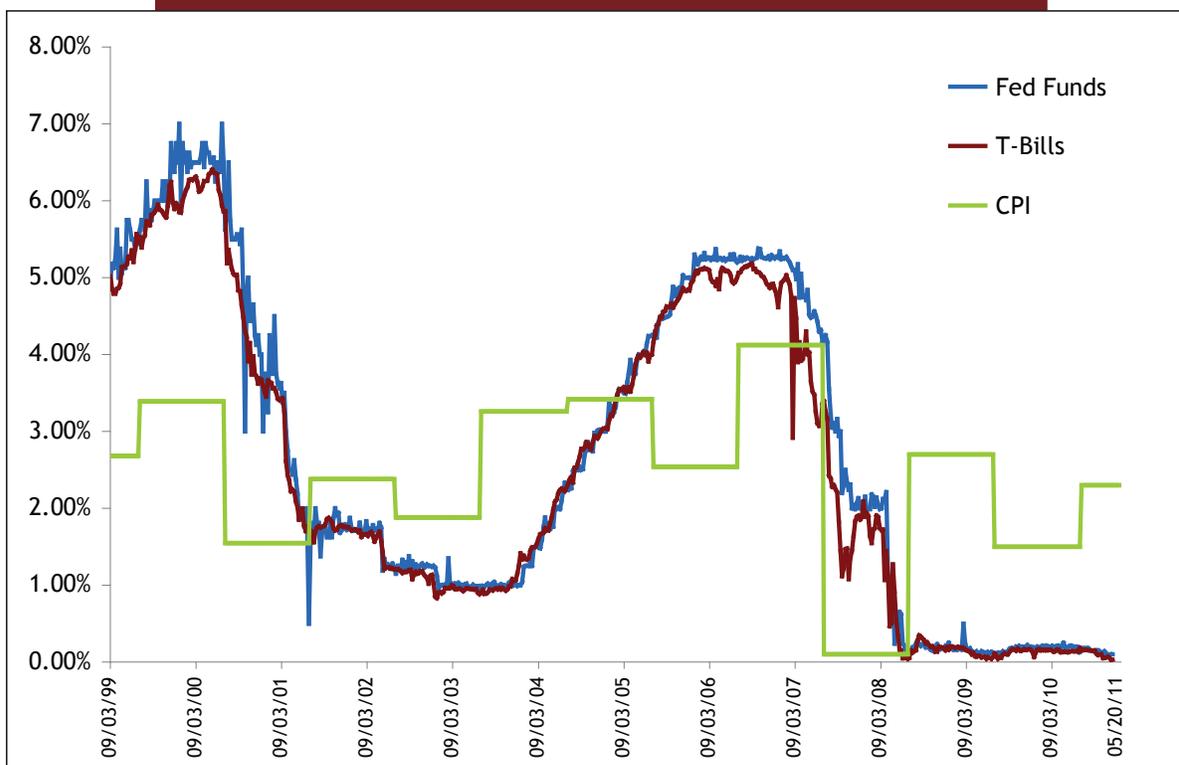
Before making our case that the stock market can continue higher after the initial increase in the Federal Funds target borrowing rates, let's define "tight" and "easy" monetary policy. While the definition may be in the eye of the beholder, we define tight policy as when the Federal Funds rate is greater than inflation. Easy policy is when the Federal Funds rate is below the inflation rate.

A higher-than-inflation Federal Funds rate (that is, a tight policy) ultimately makes borrowing very expensive relative to a basket of goods or assets.

The graph below shows the Federal Funds rate and the yield on Treasury Bills along with calendar year inflation (as measured by the Consumer Price Index or CPI). The graph starts with the fourth quarter of 1999 when policy was "tight" by ICON's definition. At the time, the Federal Reserve was trying to slow the economy to prevent rising inflation. The Fed's strategy worked, as the economy experienced a mild recession in 2001. The graph then reveals the shift in policy to an easy posture – with Fed rates lower than inflation – to stimulate the economy.

During the last economic recovery and subsequent expansion, the Federal Reserve began raising the Fed Funds rate in the spring of 2004. It took about a year and a half of gradual increases before policy became "tight" (again, defined as rates greater than inflation). Meanwhile, the stock market steadily advanced from 2003 to 2006 and hit its peak in October 2007, a year and a half after monetary policy became tight and three and a half years after the initial 2004 increase in the Federal Funds rate.

Federal Funds, T-Bills, & Calendar Year CPI (9/30/99 - 5/20/11)



Past performance does not guarantee future results. Source: Bloomberg

As past economic cycles have taught us, an initial increase in the Federal Funds rate can be a harbinger of tightening policy. When the monetary policy gets tight, however, it can take time before the stock market feels any kind of deleterious impact from the transition. Still, the stock market has posted impressive gains off the low of March 2009. We expect it to continue to advance over the next two to three years and would not let an initial boost in the Federal Funds rate change our view. ☺

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Fed Funds: In the United States, the federal funds rate is the interest rate at which private depository institutions (mostly banks) lend (federal funds) at the Federal Reserve to other depository institutions, usually overnight. Changing the target rate is one form of open market operations that the Chairman of the Federal Reserve uses to regulate the supply of money in the U.S. economy.

U.S. Treasury Bill (T-Bill): A short-term (maturities up to a year), discounted government security sold through competitive bidding at weekly and monthly auctions in denominations from \$10,000 to \$1 million. Treasury bills are the most widely used of all government debt securities and are a primary instrument of Federal Reserve monetary policy.

CPI: The Consumer Price Index (CPI) is the primary indicator of U.S. inflation and is used to make cost-of-living adjustments to billions of dollars in benefit payments.

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