

# Mitch on the Markets

## The Key Factor for Stocks in 2019



By Mitch Zacks  
Portfolio Manager

Reviewing a timeline of the Federal Reserve’s statements and actions – and comparing them to equity market action – makes it pretty clear to me that the Fed is the single most important factor for stocks in 2019.

Long-time readers know that for Zacks Investment Management, earnings revisions and earnings growth permanently hold the top spot for ‘what drives equity markets.’ That hasn’t changed. But this far into the economic cycle, and for 2019 specifically, I think the Fed’s actions and statements are especially important and influential.

Below, the chart and timeline can help bring light to this line of thinking. What you see is the S&P 500 over the last year, with call-out dates indicating key Fed actions.

### S&P 500 over the last 12 Months



Source: Federal Reserve Bank of St. Louis<sup>1</sup>

### September 26 – The Fed raises the benchmark rate by a quarter point to 2% - 2.25%

Was it a coincidence that the Fed’s interest rate hike corresponded nearly perfectly with the S&P 500’s peak in 2018? Hard to say, but the market no doubt aired its grievances with rising interest rates in the months that followed, with a ~20% decline that lasted until Christmas Eve.

The Fed was arguably justified in its decision to raise interest rates – unemployment was at 3.9% at the time, economic growth was humming along, and corporations were still experiencing double-digit earnings growth.<sup>2</sup> The economy was strong enough to absorb higher rates, and the Fed was doing its job of trying to move rates back into the neutral ‘zone,’ in my view. The market did not seem to agree.

## **December 19 – The Fed raises rates again by a quarter point, to 2.25% - 2.5%**

Economic strength showed few signs of weakening heading into the end of 2018, even though the market was experiencing pronounced downside volatility. I wrote several times that the economy and stocks were telling two different stories at the end of 2018, and the Fed's decision was based on the economic side of it.

One silver lining to the Fed's decision in December was its forecast of reducing 2019 hikes to two versus the previously stated three. The language in the Fed statement still called for "gradual" rate hikes, however, and reiterated that the U.S. economy was still growing at a strong rate.<sup>3</sup> The stock market's immediate response was to decline further, but market participants may have clung to Fed language of toning down the pace of hikes as a positive development.

## **January 30 – Fed pauses rate hikes, Chairman Jerome Powell vows "patient" approach**

The tables began to turn when the Fed toned down their hawkish language a bit in December, but it wasn't long before the markets hit full stride when the Fed said "the case for raising rates has weakened somewhat." The market saw this statement as the Fed fully walking back its previous position,

particularly since Powell added that the 2.25% - 2.5% fed funds rate was within a reasonable range of the committee's neutral rate estimate.<sup>4</sup>

The stock market responded in kind, and is arguably still locked into an uptrend that is now just a few percentage points away from claiming a new all-time high.

The Fed's plan to pause interest rate increases, in this case and in statements that have followed, may have removed a key headwind for stocks in what was already set to be a challenging year for strong gains.

## **Bottom Line for Investors**

If the Fed does indeed remain on the sidelines for the entirety of 2019, I would argue that stocks could actually post fairly solid gains for the year, assuming we also get broad-based upside surprises in earnings growth and revisions to the upside. Earnings estimates have already come down considerably to start the year, so I see this as a real, attainable possibility.

That being said, investors should also keep in mind that once rates start going up again, particularly this late in the cycle, we can reasonably expect corresponding downward pressure on stock prices – much like we saw in September and December of 2018. For 2019, it's all eyes on the Fed.

### About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

<sup>1</sup> Federal Reserve Bank of St. Louis, March 26, 2019. <https://fred.stlouisfed.org/series/SP500#0>

<sup>2</sup> USA Today, September 26, 2018.

<https://www.usatoday.com/story/money/2018/09/26/fed-raises-rate/1426946002/>

<sup>3</sup> CNBC, December 19, 2018.

<https://www.cnbc.com/2018/12/19/fed-hikes-rates-by-a-quarter-point-.html>

<sup>4</sup> CNBC, January 30, 2019.

<https://www.cnbc.com/2019/01/30/fed-chair-jerome-powell-says-the-case-for-raising-interest-rates-has-weakened.html>

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