Rate Cuts: Cheer or Jeer?

Stocks Tend to Get Lift, But Some Academics Wonder if They Should

By JUSTIN LAHART
September 27, 2007; Page C1

The idea that interest-rate cuts are good for stocks is viewed as such an absolute truth on Wall Street that it isn't even a matter of debate. But the reality is a bit more complicated.

Investors cheered when the Federal Reserve surprised the market last week with a larger-than-anticipated half-point rate cut. Academics applauded, too, because it gave them another piece of information that can be used to study the relationship between stocks and central-bank policy.

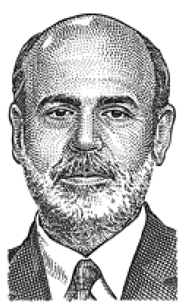
RATE REALITY

- **The Hypothesis:** Investors tend to take it as a given that interest-rate cuts are beneficial for stocks.
- **The Test:** Economists who study the perceived correlation wonder if it's so. The Fed's surprise half-point cut last week should yield more data for study.
- **The Answer:** Somewhere in the middle. While investors typically bid up shares after a cut, the long-term outcome depends on external factors.

"I wish the central bank would behave more erratically," jokes Kenneth Kuttner, an economist at Oberlin College who, with Federal Reserve Chairman Ben Bernanke, has written on the stock market's reaction to Fed policy. He sent an email to Mr. Bernanke thanking him for the fresh observation.

Sayings such as "don't fight the Fed," and "three steps and a stumble," reflect a widely held belief on Wall Street that rate cuts are good for stocks over the long term and that rate increases are bad. While stocks' short-term response to Fed policy changes appears clear, things are less obvious over the longer term.

When the Fed cut its target rate by half a percentage point to 6% at an unscheduled meeting on Jan. 3, 2001, the Dow Jones Industrial Average rose 2.8% and the Nasdaq Composite index had its best day ever, rising 14.2%. The cut was "unambiguously great news" for investors, Edward Keon, then a quantitative analyst at Prudential Securities, said at the time. "It doesn't mean everything is fine again in the world, but stocks should do fine this year."


Ben Bernanke

But by Sept. 10 -- the last trading day before the Sept. 11 terrorist attacks -- both the DJIA and the Nasdaq were well below their January levels. The Fed, meantime, had lowered its target to 3.5%. For the year, the Dow dropped 7.1%

Figuring out precisely how changes in the Fed's overnight target rate affect stocks and bonds isn't as straightforward an exercise as it appears. Fed policy is just one of many factors -- including economic data, corporate reports and political events -- that influence financial markets. So it is tough to tell whether it is the Fed that is moving prices or something else. And since investors often anticipate what the Fed will do with rates weeks ahead of time, any financial-market reaction may have been baked into prices long before rates were changed.

Economists hit on the idea of looking at changes in the Fed's target federal-funds rate that weren't widely expected, using interest-rate futures to determine if a rate move was, in fact, a surprise. To limit the effects of other market influences on their observations, they concentrate on short-term market movements after a policy change, sometimes narrowing their focus to as little as 30 minutes.

But while rate movements used to regularly surprise the markets -- especially before 1994, when the Fed didn't announce policy changes -- the Fed's push for increased transparency has meant that in recent years few of its rate moves

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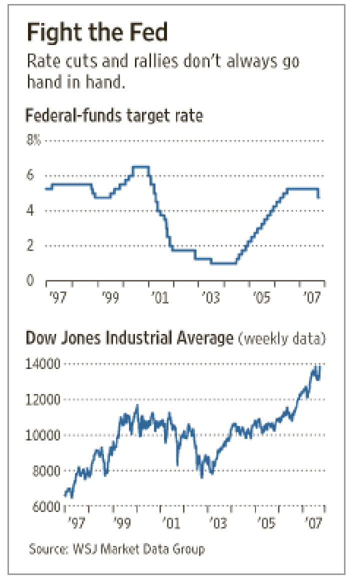
have been unexpected.

"The problem from a research perspective is that the Fed became so predictable," says Macroeconomic Advisers economist Brian Sack, who, with Eric Swanson at the San Francisco Federal Reserve Bank and Refet Gurkaynak at Bilkent University in Turkey, has studied the effect of monetary policy on markets. "It's harder to isolate the effect of monetary-policy actions on financial markets because we don't get clear instances where we get a substantial policy surprise."

Last week's rate cut was the first real surprise from the Fed in more than four years. Stocks staged a massive rally, sending the Dow industrials up 335.97 points, or 2.5%, to 13739.39. But the 10-year Treasury note edged lower, nudging its yield slightly higher. The reaction was in keeping with what the researchers found tended to occur when the Fed cut rates by more than expected in the past: namely, stocks go up, but long-term Treasurys barely move at all.

"It's nice to have another data point," says Mr. Swanson. "It's even nicer that it fits in with our previous findings."



Federal Reserve economist J. Benson Durham, who has written on the long-term response of stock markets to central-bank policy changes in the U.S. and 15 other countries between 1956 and 2000, has found little evidence that periods where rates were falling have been better for stocks. "Indeed, according to the monthly data for the most recent period, tightening monetary policy has a significantly *positive* average effect in the panel of countries," he wrote in 2003.

Mr. Durham also has pointed out that gauging stocks' long-term reaction to the Fed is complicated by what is known as the simultaneity bias -- that is, not only do markets react to what the Fed does, the Fed may react to what the markets have done. "Asset prices have mattered in the determination of policy because they have mattered for the outlook," Fed Vice Chairman Donald Kohn said in Germany last week. "I am confident that the federal-funds rate wouldn't have been as high in 2000 if it had not been for the level of equity prices that year."

Prof. Kuttner thinks that it makes sense that after investors' initial response to a policy surprise there is little in the way of measurable follow-through. The change in rates has, after all, been priced into the market. What's more, that initial movement can quickly be overwhelmed by other forces.

"There's this jump in levels, but going forward, stocks can be bumped around by all kinds of things," he says.

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