VAKIFBANK GLOBAL ECONOMY WEEKLY

Impacts of Rate Hikes On Markets:
Fed and ECB rate hikes

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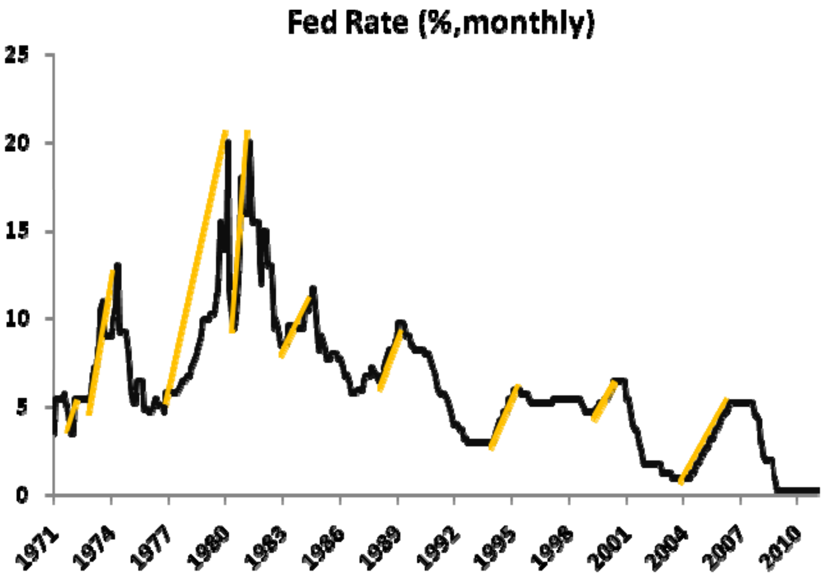
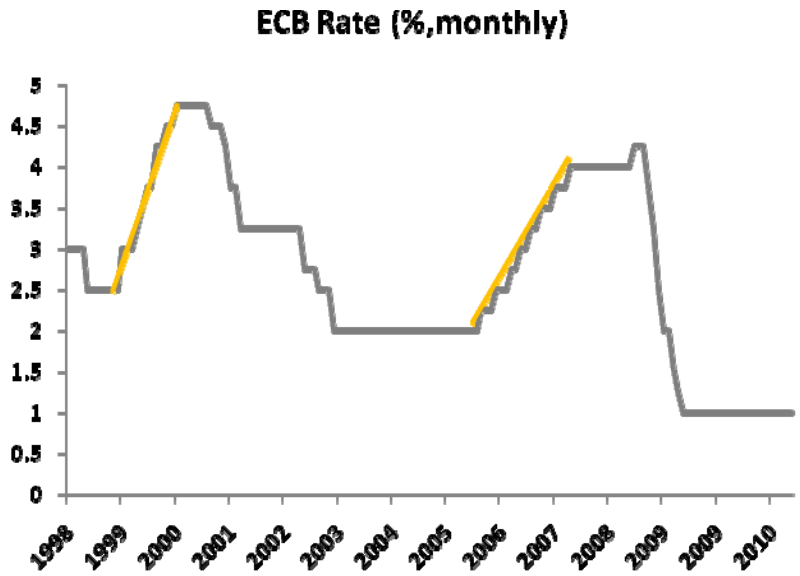
Introduction

Rising commodity prices and high inflation rates have recently forced many emerging economies to hike rates. In this environment markets are concerned about Fed and ECB's monetary policies in the near future. From the past until today Fed rate hikes have been an important market indicator and have shaped cash flows globally. In this study, the impacts of Fed rate hikes are analysed under four headings as stocks, bonds, commodities and fx markets. Since ECB is expected to hike rate before Fed for the first time, possible effects of this hike on markets are also discussed.

➢Impcats of Rate Hikes on Markets...



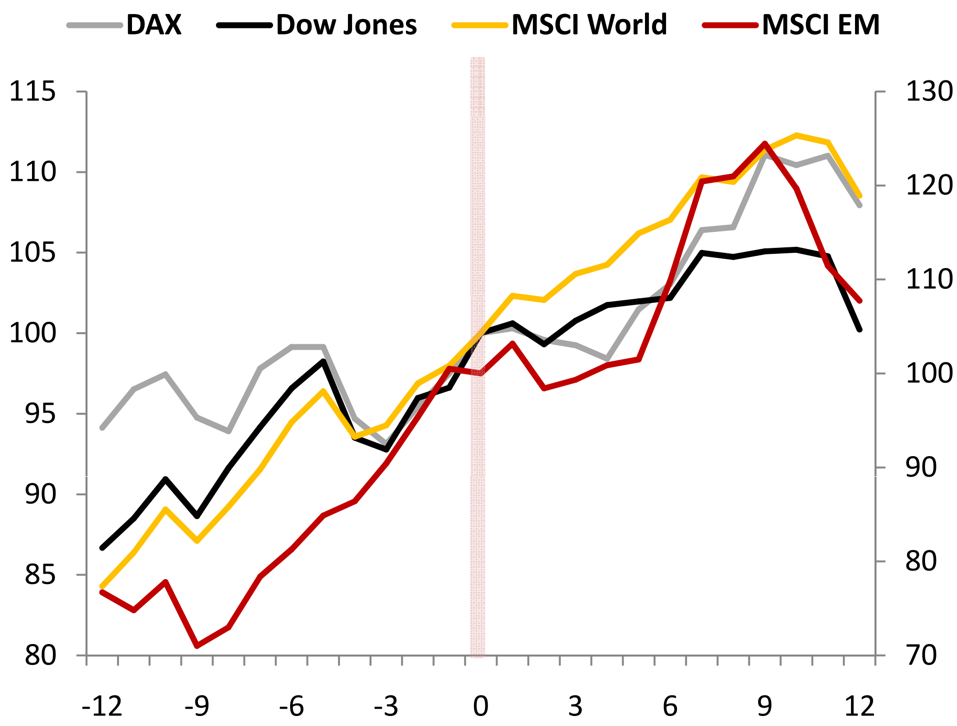
Source: Bloomberg



Source Bloomberg

- In the study, all Fed rate hike cycles since 1970 are analysed. Historical analysis is mainly based on cycles initiated by the Fed. Since 1970 there have been 26 occasions when the Fed has followed a rate cut with a rate hike. However in our analysis, 9 distinct cycles of monetary tightening are considered. In order to compare different time series, monthly Fed rates since 1970 are indexed to 100 and the start of a cycle of rate hikes are accepted as zero.
- An unconditional mean return for each asset class for each number of time periods is calculated. The performance of asset classes in the 12 months before and in the 12 months after the each Fed hike are compared in order to determine whether there has been a better than, or worse than, average performance during the period.

➢ *Impacts on stock markets...*



Source: Bloomberg, Vakıfbank

- The performance of the stock markets in the 12 months before and in the 12 months after the Fed rate hike for each 9 periods are compared in the LHS graph. It is observed that;

✓ Stock markets began to rise 3 months before the rate hike with hike expectations.

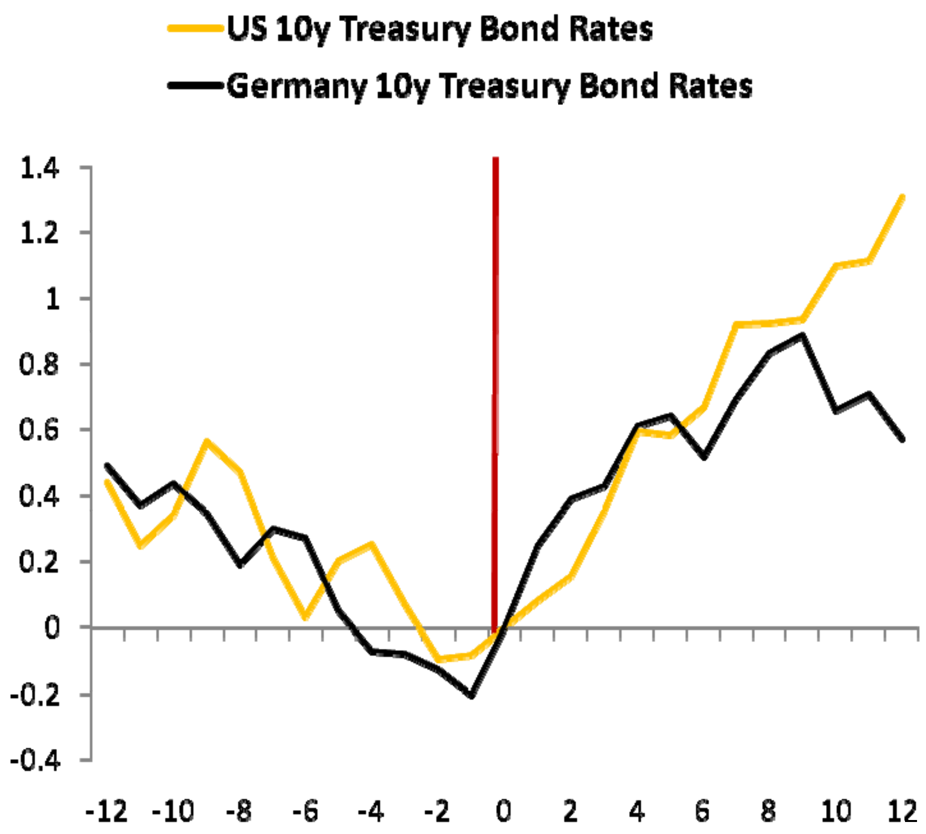
✓ These increase lasted for 9 months and after 9 months the sales started.

✓ Beetween indices which are examined, the worst-performing indices were MSCI EM and Dow Jones.

- On the other hand, the performance of the stock markets in the 12 months before and in the 12 months after the each ECB's rate hike are examined under 2 periods (October 1999, November 2005). It is observed that;

✓ In 1999, stock markets rose about 3 months, in 2005 stock markets rose about 6 months. And the most severe rise experienced in DAX index. After these periods, sales started.

➢ *Impacts on bond markets…*



Source: Bloomberg

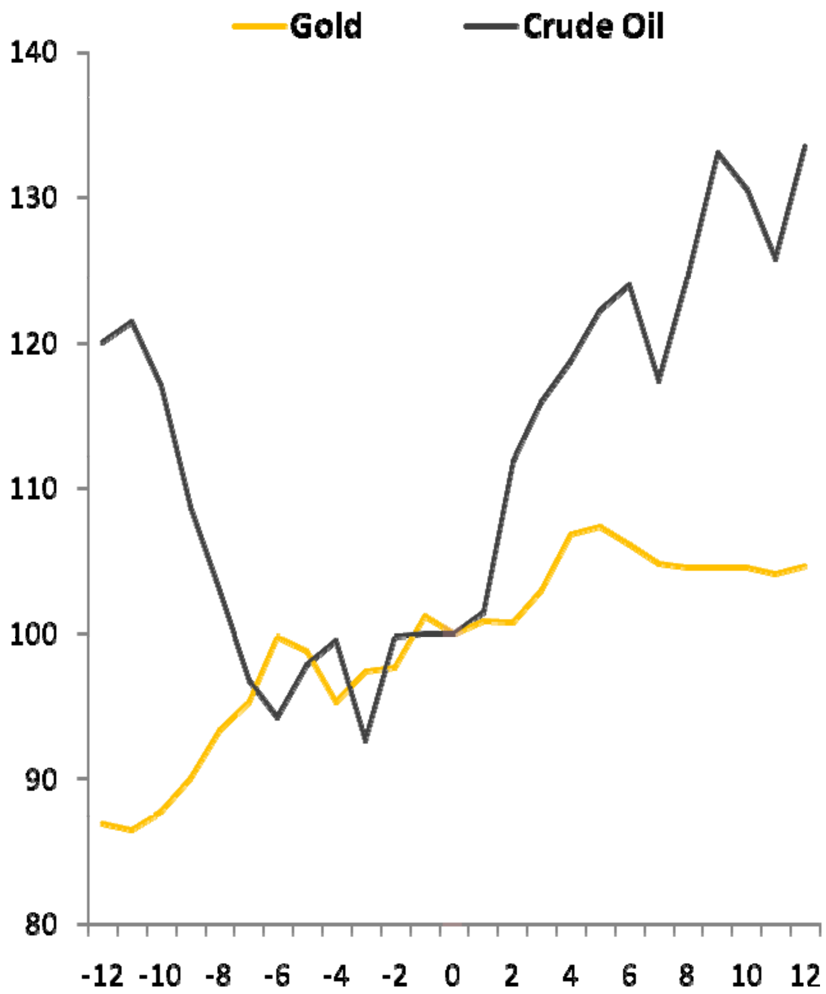
- In the selected 9 periods, US and Germany 10 year Treasury bond rates decreased with safe heaven demand in the 12 months before the hike.

- During the first 12 months after the start of a tightening cycle, US 10 year Treasury bond rates increased by 1.3 basis point (bps) while Germany 10 year Treasury bond rates increased by 0.5 bps.

- However 9 months after a hike, two bond rates decoupled. US 10 year Treasury bond rates continued to increase while Germany 10 year Treasury bond rates decreased between the 9th and 12th months.

- ECB raised interest rate in October 1999 and November 2005. Bond rates increased during the first 7 months after the hike and started to decrease after these months.

➢ *Impacts on commodity markets...*

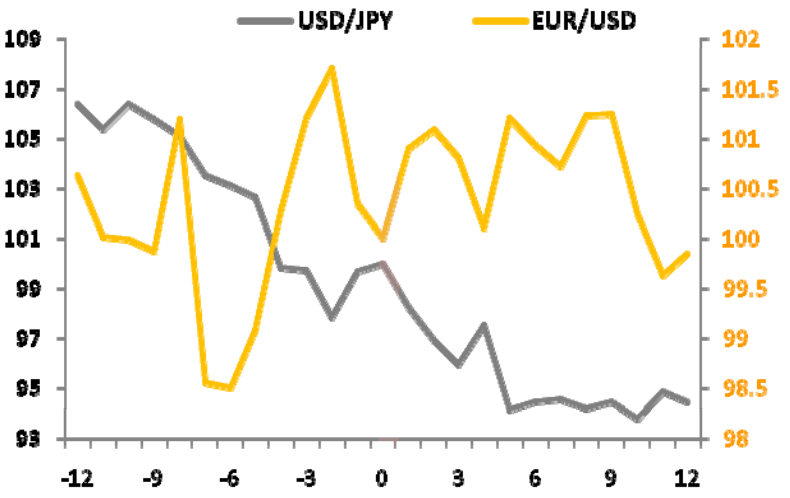


Source: Bloomberg

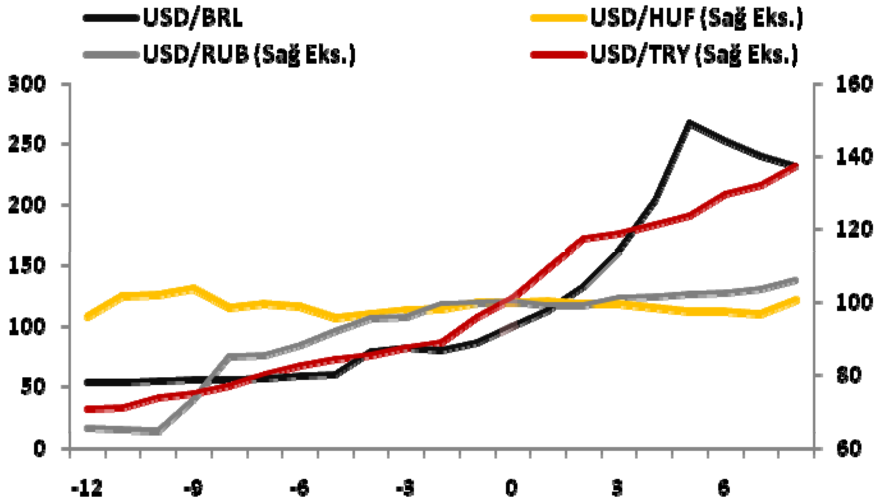
- Gold and oil prices have decoupled during the crisis times.
- Due to declining investment and production, oil demand falls in crisis times and aforementioned fall causes a decrease in oil prices. As gold is perceived as a safe investment vehicle, gold demand increases during the crisis times.
- After the rate hikes, the holding cost of gold increases. Due to cost increases, gold demand and price decline in these periods.
- Nowadays, not only demand and supply specify the commodity prices but also investors behaviors' are affected on the volatile prices.

➢ *Impacts on FX markets…*

When the performance of the fx markets in the 12 months before and in the 12 months after the Fed rate hike for each 9 periods are compared, it is observed that the impacts of rate hikes on fx markets are not obvious as in other markets. When the impacts of rate hikes on major currencies as euro and yen are examined, it is observed that EUR/USD decreases as dolar starts to increase aganist euro 5-6 months before the hike. EUR/USD decareses after the hike due to structural problems of US. USD/JPY increases on rate expectations 3 months before the hike and starts to decrease after the expectations have realized.



Source: Bloomberg, Vakıfbank



Source: Bloomberg, Vakıfbank

When the efects of Fed rate hike on emerging countries' currencies are examined for 3 periods since 1999 and it is observed that dolar increases aganist these currencies after the rate hike.

The impacts of ECB rate hike on markets are also analysed for 2 periods. It is seen that EUR/USD rises on rate expectations before rate hike, and starts to fall down with dolar buying after the hike.

To sum up;

- *Since US inflation rate is relativeley lower compared to Euro Zone, with dual mandate of FED (stable labor market and stable inflation) is not expected to start rate hike before 2012.*

- *On the other hand as inflationary preassures in Euro Zone rise due to high food and commodity prices, ECB and BOE are expected to start hiking interest rates before Fed. However interest rate hike of ECB is expected to be limited.*

- *Since euro is neither global reserve currency nor cary trade ones compared to US dollar, the expected ECB rate hike might be less problem on emerging markets.*

- *On the other hand, possible FED rate hikes will be more effective on the markets since US has structural problems such as high twin deficits. Furthermore US dollar is used in carry trade transactions by market speculators. If Fed start hiking earlier than expectations, market players will rush in to close their short positions which will increase the volatility especially in EM. However historical data shows this initial negative reaction will eventually subside and market players will restart to entry EM thus EM currencies may appreciate against other currencies.*

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