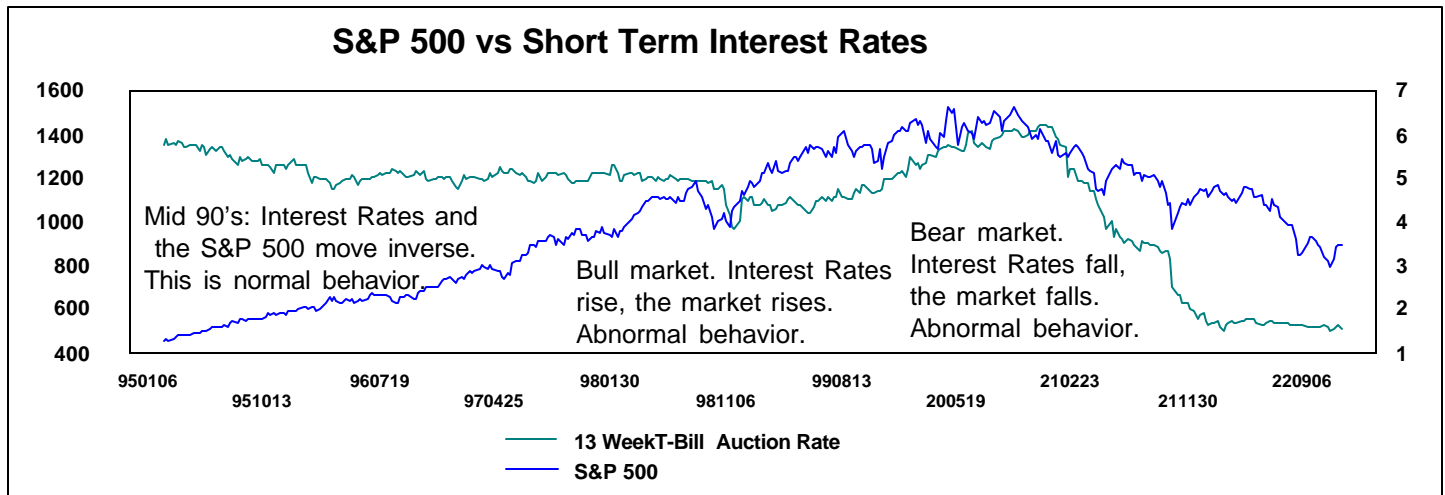


Have short term interest rates been affecting the S&P 500?

by Howard Spieler



As you probably already are aware, Alan Greenspan and the Federal Open Market Committee (FOMC) chose to cut rates on Wednesday, November 6, 2002 for the 12th consecutive time. The 50 basis point cut was larger than expected and gave optimists reason to cheer (falling rates can only help stock prices) and pessimists a reason to worry (economic conditions must be worse than expected).

Historically speaking, stock prices and interest rates (at least shorter term interest rates) move opposite of each other. When interest rates are rising, in general, stock market prices tend to weaken. When rates are falling, the stock market generally performs better. In fact, Systems and Forecasts has several economic models that we use to augment equity trading strategies that have been very successful.

However, starting in 1999, interest rates and stock prices began to move in tandem, a rare occurrence in economic terms. During the bull market, investors flocked to stocks, driving them to never before seen levels based on historical measures of stock valuation. The Fed raised rates in an attempt to cut off inflation (there had been no real inflation threat yet) and slow down spending and "irrational exuberance", but the markets continued to rise along with interest rates.

After the first wave of the stock market decline in 2000, earnings began to fall. Then economic conditions started to slow down. Then we had Enron and the accounting scandals. Then 9-11. When the dust cleared, interest rate cuts alone were not enough to slow down the severe market decline. The markets were falling at such a steep pace that interest rate cuts could not prop up the market by themselves (or, apparently, to cure the slowdown that has been infecting the overall economy).

Implications: Can the 12th interest rate reduction be the lucky charm? Will this cause the ripple effect throughout the economy that the FOMC is looking for? We are skeptical. Clearly the problems with the economy and the stock market have not been interest rates (they already were at their lowest levels in forty years) but something more fundamental. Everything may work out just fine, but we do wonder whether Alan knows something we do not.