

BY STEPHEN BRENNAN

# Fighting the Fed

**SO FAR, 2004 IS LOOKING A LOT LIKE 1984.**

This year, the Federal Reserve is clearly moving toward boosting short-term interest rates, as it did in '84. Both years were also the first election years following a big bear market. This is not the first time I've drawn market cycle parallels; I previously predicted that, as had been the case in 1983, last year would surprise folks with much stronger than expected economic growth and stock market gains. In '84, however, stocks chopped sideways, digesting the healthy gains of '83 before surging higher in 1985. After the strong gains of 2003, I believe we are in the midst of a similar sideways consolidation period that presages another powerful rally in stocks – probably later this year, but possibly not until 2005.

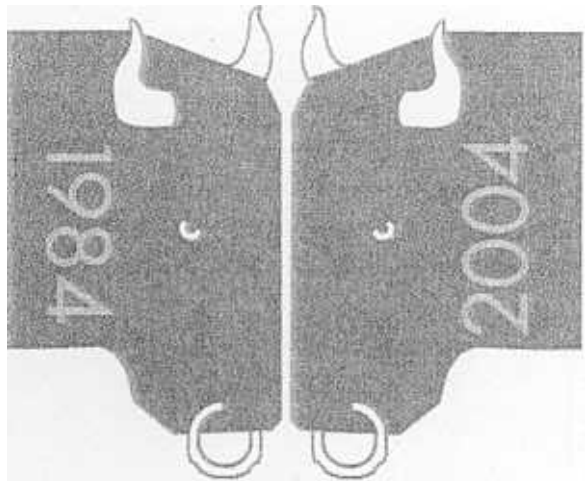
## THE FED AND STOCKS

Stocks, including those of semiconductor companies, recently moved lower because of concerns about interest rates. Higher rates are never welcomed by investors, but historically Fed interest rate tightening is not always bad for stocks. As was the case in '84, 1994 also saw a market correction and sideways price action that overlapped with Fed rate tightening in a post-recession recovery. If '04 turns out to be like '84 and '94 then stocks could finish slightly negative for the year, before running much higher in 2005, despite higher rates.

However, some might argue that the stronger historical comparison for this decade is the 1930s – the bull market of the 1990s looked an awful lot like the roaring '20s, and the bear market that lasted from spring of 2000 to the fall of 2002 was of almost equal duration to that of 1929-1932. While the 1930s would see another devastating bear market start in 1939, the three-year period following '32 was nonetheless very good for stocks. In addition, the other two multi-year bear markets of this century (the 1939-1941 and 1973-1974 bear markets) were both followed by two years of consecutive positive returns.

## WHEN TO CUT AND RUN

Sometimes it pays to fight the Fed, and investors who were



spooked out of stocks by rising interest rates in 1984 and 1994 missed out on powerful rallies. Of course, there are times when it's better to abandon stocks, but this has usually been the case when the Fed is tightening to fight already-significant inflation. The 1987 market top that followed five years of a bull market may be the exception that proves the rule, when tighter monetary policy, absent high inflation, overlapped with the October crash. Given our current low inflation environment and being less than two years out from a major bear market, however, I believe worries over the 1970s and 1987 are best saved for later in the current market cycle.

Don't get me wrong. I am actually very concerned about inflation longer term, as most of the necessary components are clearly in evidence: very low rates, rising commodity prices, and – recently – signs that hiring is finally picking up. Of course, excess manufacturing capacity remains high at just over 20 percent, and, if the U.S. dollar strengthens this year (as I expect it will, which would be different than 1987), it is unlikely that inflation will return with a vengeance. That may give the Fed some breathing room, but looking out to 2005 and 2006, the Fed appears to be behind the curve and facing a lose-lose proposition – raise rates aggressively now and risk damaging the recovery (not to mention stock and bond investors), or move more slowly and risk an inflationary snowball. While the Fed will most certainly raise rates this year, the latter risk seems more likely, and that raises serious questions for stocks when I look out more than a year. But for now, I'm planning on holding my ground and staying long. ☺

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