Economic Update

Broadleaf Partners, LLC

Fun with Charts

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My Excel charting skills are indeed amateur, but I nevertheless wanted to get a feel for the historical relationship, if any, between changes in the Fed's discount rate and the stock market. If you hadn't heard, the Fed raised the discount rate by 25 basis points after the close of the market last night to 75 basis points. Changing the discount rate - the rate the Fed charges banks for loans - is one of the many monetary policy tools available to the Federal Reserve.

CNBC is providing intense coverage of the Fed's moves this morning, basically asking professional investors if the Fed's moves signal anything about a change in policy that may usher in additional rate hikes and what that might mean for the markets. Bulls might interpret the move as a sign that the Fed is more comfortable with the economic outlook and is therefore taking initial steps to remove temporary stimulus that may no longer be necessary. On the other hand, bears might argue that the move may be the first in a series of many hikes in the *Fed Funds rate*, moves which may prove too little too late in fighting inflationary pressures brought about be easy money.

The first chart (next page) shows the discount rate and associated changes since 2003. In the chart, you can see two primary monetary policy campaigns. The first is the period from 2004 to mid 2006 when the Fed raised rates as the economy recovered from the tech wreck earlier in the decade. The second period was from 2007 to just before last night, when the Fed reduced the discount rate to nearly zero to combat what almost became a second Great Depression. The second chart shows the S&P 500 over the same time period, with the blue dots representing dates when the Fed changed the discount rate.

To me a couple of observations and conclusions might be made from these charts. First of all, it is likely that yesterday's increase in the discount rate may indeed represent a change in Fed policy and that barring a double dip in the economy, will prove to be the first of many such rate hikes. However, what is also interesting is that the last time the Fed started to raise rates, the S&P 500 climbed higher from roughly the 1100 level in mid 2004 to the high of 1567 three years later, when the Fed first started to cut rates once again.

To me, the data suggests that investors need not panic. The time to worry about Fed policy may not be for a few years, or at least until the Fed ends its rate hike campaign and begins cutting them once again. If history is a guide, rate cuts won't likely occur until a period of economic expansion is over and the Fed begins to worry once again about signs of visible economic weakness. Until then economic growth and even some inflation will likely be interpreted by the stock market in a positive light.

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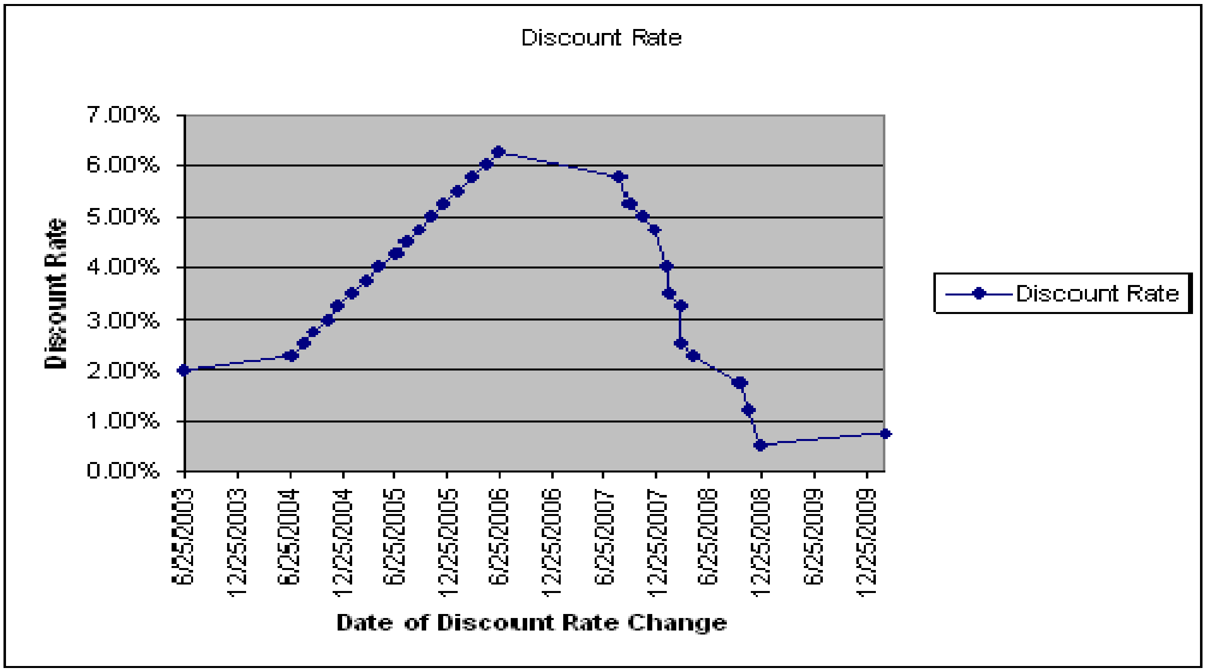

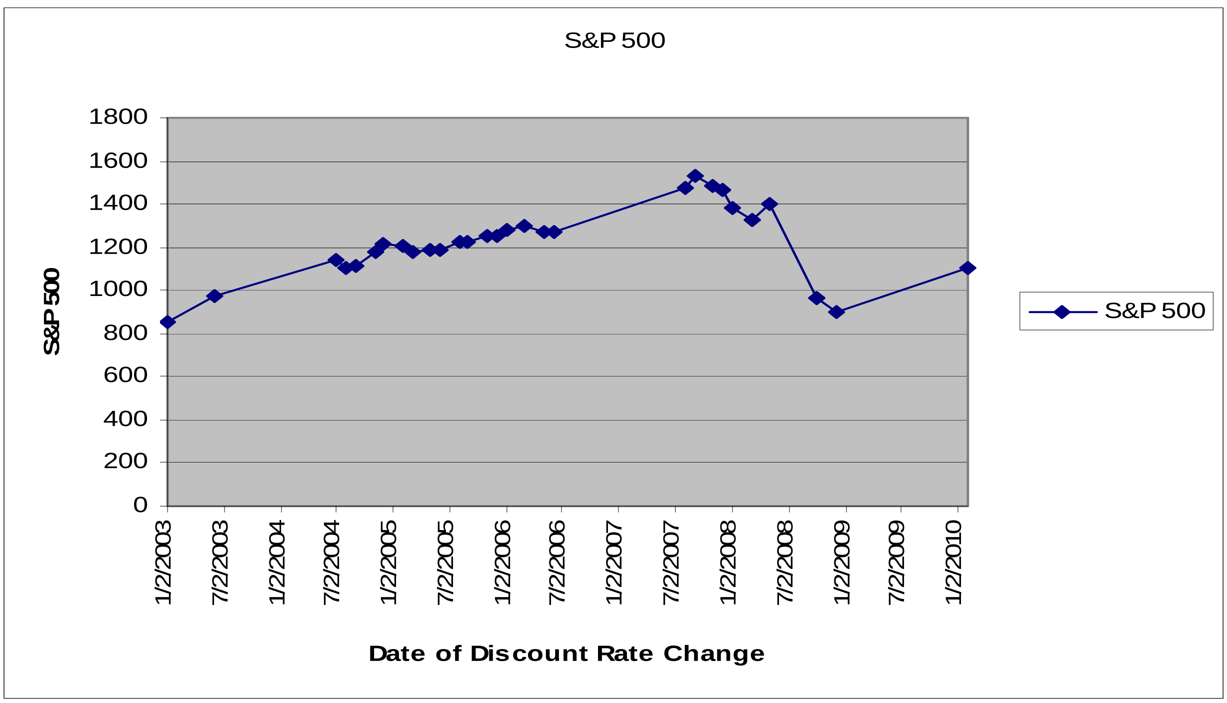

Kindest Regards,

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