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The Street

How the Fed's Actions in April Will Impact Stock Market Returns

By **Ellen Chang** Follow| 04/04/16 - 11:27 AM EDT

The Federal Reserve is likely to leave interest rates unchanged in April, raising the potential for more volatility in the stock market.

The central bank held rates steady when it met in March and also back in January amid the large swings in the market as oil prices plummeted to record lows and fears of a global slowdown rose. The pace of rate hikes is predicted to decline in 2016.

"The market's assessment of a likely interest rate hike in April remains miniscule," said Edison Byzyka chief investment officer of Hefty Wealth Partners in Auburn, Ind. "The probability currently stands at less than 10% and given the dovish dot plot in March, the probability is likely to drop closer to 5%."

The probability of a rate hike in April remains very low although recent remarks by several regional Fed bank officials "indicated that there was a credible case to be made" for the Fed raising rates next month in April, said Robert Johnson, president of The American College of Financial Services in Bryn Mawr, Pa.

Effect on the Market

When interest rates start to rise, the returns of the stock market are “markedly lower than when rates are trending downward,” he said. The S&P 500 returned 15.2% annually when rates were falling from 1966 through 2013 and only 5.9% when rates were rising.

Stock market volatility also tends to decline when interest rates are in a rising rate environment compared to when there is a declining rate environment. During falling rate environments from 1966 through 2013, the standard deviation of annual returns was 16.3%, Johnson said. When interest rates were increasing, the standard deviation was only 14.4%.

“Investors should not assume that volatility will be higher as rates rise,” he said.

The glide path of interest rates will continue to impact the market’s returns, said Matthew Tuttle, the portfolio manager of Tuttle Tactical Management U.S. Core ETF (TUTT).

“Markets rallied on dovish comments from Yellen and then started to weaken when they saw dissension in the ranks,” he said. “The Fed remembers what happened in December when they raised rates and the market declined 10%.”

Increasing interest rates too soon could dampen returns, and now the Fed is “between a rock and a hard place,” Tuttle said. “They would like to normalize rates, but they don't want to be responsible for a massive market decline.”

The Fed is likely to hold off on raising rates for awhile unless “we get economic data that is too good to ignore,” he said.

In the near term, investors must cope with continued volatility until the Fed increase rates from 0.25%. “This means that the choppy markets that we saw last year and so far this year are here to stay,” Tuttle said. “We will see tons of volatility, but it is unlikely the market will break out either way until Fed policy becomes clearer.”

Investors are facing headwinds since activity in the market will continue to have “large up and down swings,” but is likely to still yield flat returns, he said.

“Once the Fed starts tightening, that will be the nail in the bull market coffin,” Tuttle said. “Investors need to take a tactical approach because buy and hold and asset allocation just won't work.”

The markets will not generate large returns this spring and investors should focus on maintaining a global diversified portfolio and take advantage of buying stocks while they are cheaper, said Jon Ulin, a managing principal of Ulin & Co. Wealth Management in Boca Raton, Fla.

“Just remember it’s all about your time in the markets and not timing the markets,” he said. “It is highly possible for the U.S. market bulls to run a few more points this spring and recapture their highs from last year. It may be difficult for the S&P 500 index to make a clean breakthrough before the end of this year of the high of 18,312 set last May.”

Focus On Earnings Season

At greater stake is the upcoming corporate earnings season and the market could continue to trade "sideways to slightly lower in the spring" because of the current earnings per share projections for the first quarter, Byzyka said.

Global economic concerns such as China's weakening economy will not improve soon and the country's GDP announcements will be "highly scrutinized in terms of accuracy and growth prospects, providing for likely excess volatility irrespective of the absolute data," he said.

Despite the market rebounding in March from the declines in February, the needle has not moved much for the S&P 500, a benchmark index, said Jerry Braakman, chief investment officer of First American Trust in Santa Ana, Calif.

The concern now is on the lack of earnings growth in the U.S. market as many industries, including manufacturing, energy and housing face continued weakness.

"We have passed peak earnings several quarters ago and these sectors are indicative of potential deceleration in the economy," he said. "Earnings deceleration is of particular concern as earnings drive markets over the longer term."

When Fed Will Raise Rates

The Fed is not likely to increase rates in April, but if the core inflation continues to improve, the central bank could raise rates as soon as this summer and again later in the year, Braakman said.

While the recent employment data is "somewhat more positive," wage growth has remained stagnant, said C.J. Brott, founder of Capital Ideas, a registered investment adviser in Dallas and a portfolio manager with Covestor, the online investing marketplace.

First quarter U.S. GDP figures are expected to be weak with anemic domestic economic growth, he said. The Fed could stall raising rates until December, after the presidential election.

"Although they might want to raise them sooner in order to prove their metal, I do not think they will want to do so late in an election year and seem political," Brott said.

Until more positive economic data is generated and investor confidence builds, the Fed will hold off on making another interest rate move, said Dave Louton, a finance professor at Bryant University in Smithfield, R.I.

"I think we're more likely to see an interest rate hike later in the year after these factors have had time to come into better alignment," he said. "I think that at this point the Fed has almost an implied contract with investors to leave interest rates alone for the time being."

Volatility in the market will become the new norm due to the increase in the potential of "expanded terrorist activity, rising prices for oil and their potential to slow global economic growth," said Brott.

Investor enthusiasm will be dampened with the lack of earnings, economic and wage growth over the next several quarters.

“While the lows for the market were set in February, the market indices will probably be unable to set new highs in the next three months,” he said.