



Research Note

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No one can deny the powerful stimulative effect of the Federal Reserve's fourth quarter interest rate reductions on the economy and the stock market. The economy grew at an annualized rate of 5.6% during the fourth quarter, led by a rebound in construction spending and auto sales, while the S&P 500 returned 26.37% for the four months ended January 29th. However, the stock market's rally has been narrow, with internet related stocks, financials, and other cyclical issues the prime beneficiaries. If stocks in the technology, communication services and financial sectors are excluded, the remaining stocks in the S&P 500 delivered an average return of less than 16% over the October to January period. In fact, many have not yet fully recovered from the market sell off of July and August.

What is even more troubling is that the scope of the rally continues to narrow. During January, the technology and communications services sectors, which represent less than 30% of the S&P 500's market capitalization, accounted for more than 90% of the S&P 500's 4.18% return. The remaining stocks in the S&P 500 returned an average of less than 0.50%. Outside of the liquidity driven feeding frenzy for internet related issues, the broad stock market has been stagnant.

Stocks that offer safety and stability have been particularly out of favor. Given the Federal Reserve's apparent willingness to provide a liquidity cushion for speculators, investors have seen little need for holdings that offer steady but less than spectacular growth. To illustrate, we have applied one of the stability measures from our research tool kit to the S&P 500 Index as of September 30, 1998. For each stock in the index, we recorded the absolute value of its' monthly return for a series of months ending with August 31, 1998.

An average of these absolute returns was calculated for each stock and the averages were then used to sort the S&P 500 into 5 groups of 100 stocks each. The 100 stocks with the lowest averages were placed in group 1. These are the stocks that have exhibited the greatest return stability in the past. The 100 stocks with the highest averages of absolute monthly returns were placed in group 5. These are the stocks that have exhibited the greatest return volatility in the past. The table shown on the next page reports the capitalization of each group as of September 30th, as well as the capitalization weighted return to each group for the months from October through January.



Returns of S&P 500 Stocks Ranked By Past Return Stability

Stability Group	S&P 500 9/30/98 Weight	October Return	November Return	December Return	January Return	4 month Return
1	21.94%	5.41	3.14	1.75	-2.41	7.96
2	21.74%	7.51	4.76	3.82	-1.29	15.41
3	21.88%	9.49	6.73	4.18	2.36	24.62
4	18.66%	7.93	6.75	8.63	7.64	34.73
5	15.77%	10.22	9.98	13.01	15.92	58.80

As you can see, returns were fairly evenly distributed across the groups at the beginning of the market's rally in October. As time progressed, however, the stocks benefiting from the Federal Reserve's injection of liquidity were those concentrated in group 5, the most volatile stock group. As the economy slows in coming quarters, this trend should reverse itself as investors return to the safe haven of more stable stocks.