Investment Update

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The Fed's Next Trip Up

I used to take a regular commuter flight from Denver to Santa Fe that was notorious for air turbulence. The flight path was over the Rocky Mountains, and the pilot would navigate the 20-seat propeller plane across a roller-coaster trajectory to avoid dangerous air pockets—with a laptop propped in his lap feeding him live weather images. On one especially rocky crossing, a woman who had never made the trip before suddenly hunched over in her seat in front of me with her fingers gripping the arm rests for dear life. I leaned forward and tapped her on the shoulder. "Don't worry, the pilot does this trip four times a day. This is routine for him."

Many investors have been buckling up to prepare for the Federal Reserve's plans to begin raising interest rates—by mid-2015, according to our forecast. After years of record low interest rates and unprecedented "pedal-to-the-metal" Fed policy, some investors are understandably bracing for market volatility and muted returns once the Fed's trip back up finally begins. However, unlike the Denver/Santa Fe flight path, the Fed's next trip is likely to be muted and measured, with little dramatic impact for months, even years. Investment opportunities are just as likely as new risks will be, as rates start to rise.

A Different Trip—Three Reasons Why

The next Fed cycle of rising rates may be different for a number of reasons. For starters, the Fed has never started raising either the federal funds rate or the discount rate from zero. This fact alone is significant. When the Fed begins raising rates from these historically low levels, the first few hikes may have little effect because it will take a few hikes just to get back to the starting point of past rate cycles. This could potentially bode well for markets.

The rate hikes next year could also be more than offset by the European Central Bank and the Bank of Japan. Both the ECB and the BOJ should be continuing to take steps to stimulate growth in their regions by utilizing easy monetary policy and various forms of quantitative easing.

The Fed is also projected to increase rates in increments of only 25 basis points. While the Fed reserves the right to raise rates by any amount, the current consensus is that a slow and steady rise is the most likely. Some Fed officials have been vocal in advocating this approach, including Chicago Fed President Charles Evans, who said the Fed should be "exceptionally patient" in its decision to raise rates.

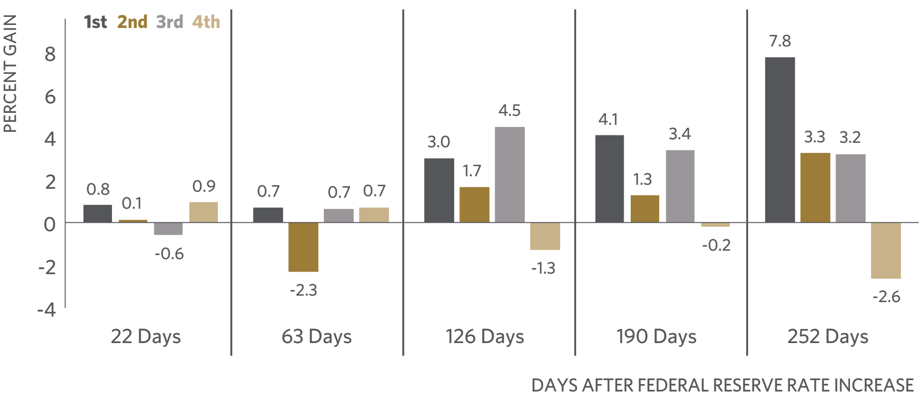
Impact on Stocks and Bonds

Each of these differences may serve to lessen the historically negative impact rising rates have had on stock prices and bond yields.

Within stocks, the old adage, "Don't fight the Fed," would posit that it's time to sell when the Fed is about to raise rates. We do not share this view. While the Fed's actions will put an end to the liquidity-induced phase of the current bull market, and may slow future growth, we think stocks can continue to push higher in the intermediate term. Why? Consider Exhibit 1 (on the following page), which looks at how the Dow Jones Industrial Average typically fares after the Fed begins raising rates. As the Exhibit shows, markets are volatile for the first 22 days, and even into the 63rd trading day. After this point, a clear pattern emerges. Markets are generally higher 126, 190 and 252 trading days later. Only after the fourth rate hike have the markets reacted negatively, and that historically has been only to a very small degree.

Exhibit 1—Rate Hikes Aren't Always Bad for Stocks

DJIA Performance after Federal Reserve Rate Increases 1971-2014



Source: Ned Davis Research.
Using Discount Rate from 12/21/1917 to 12/30/1988 and Fed Funds Rate from 1/3/1989 to 9/2/14.

Another way to look at the effect rising rates have on equities is to analyze what happens to price-earnings multiples. In the spring, we wrote about how multiples can remain near their current levels (about 17X earnings) even if real rates on the 10-year bond increase by 200 basis points (2%). History shows that real yields on the 10-year bond would have to rise to over 4% from the current rate of approximately 2% for P/Es to be slightly negatively affected. Real yields on the 10-year would have to rise to over 6% to put significant downward pressure on multiples.

Even small cap stocks, sometimes seen as a proxy for a more risky equity asset class, have shown resilience to rising federal funds rates historically. Analyzing data going back to 1980, small caps historically have moved higher after the first rate hike. This holds true, on average, for periods as short as 30 days to as long as 18 months, with returns averaging just over 10% in the latter cases.

While stocks demonstrate resilience to the Fed's initial moves, bonds, of course, don't fare as well. After the Fed begins raising the discount rate, the yield on high-quality, long-duration corporate bonds increases as well. This is true in periods of time ranging from one month all the way to up to one year after the hikes have begun. As yields rise, bond prices fall, hurting investors' total return.

That said, we continue to believe that bonds play an important role in client portfolios, providing both income and diversification benefits. As rates rise, investors should remember that as bonds mature in their portfolio, the proceeds will be invested at higher yields, increasing the income generating power of the bond portfolio overall.

Conclusion

Beginning in mid-2015, we anticipate an end to the easy monetary policy the Fed has followed for the past five to six years. While longer dated fixed income assets might be slightly negatively affected, we believe the economy, and most equity markets, will weather the initial hikes quite well, probably rising in the process. Stronger underlying economic growth, should more than offset the drag slightly higher rates will have on the economy as the Fed begins the process of normalizing interest rates. It is more likely that the later rate hikes, done when the Fed is trying to fight off inflation and strong growth, will be cause for the most concern. However, we don't see that as a threat for some time to come. In the meantime, investors should be ready to seize upon attractive new opportunities.

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