Investment Update

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It's not the heat, it's the humidity

As the cold starts to make its way into New England, many of us are contemplating vacations to warmer, more habitable climates, like Florida. Anyone who has visited the Sunshine State, or the eastern seaboard during summer, can appreciate the true meaning of the title of this piece. As we await clarity on the Federal Reserve's (Fed) decision to raise rates, I believe this is an apt analogy to compare the Fed's first rate hike (the heat) versus the pace at which it will continue to increase short-term interest rates (the humidity).

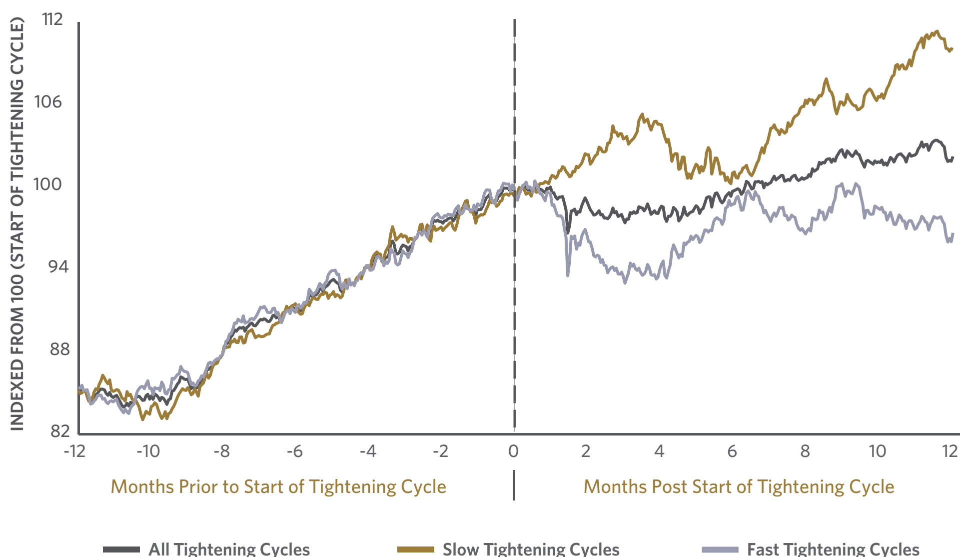
Though the timing of the first rate hike has been much debated, we expect that the first rate increase is drawing near. Recent strength in economic data, especially the November non-farm payrolls jobs report, which showed the creation of 211,000 non-farm jobs and an unemployment rate to 5.0%, supports our belief that the Fed will be ready to raise rates at its December meeting. Fed officials have been vocal as of late, seemingly to prepare markets for its first rate hike in nearly a decade. Fed Chair Janet Yellen commented that a December hike is a "live possibility" if incoming data is supportive of a growing economy, improved labor markets, and a return to 2% inflation. With the December FOMC meeting nearing, let's discuss the raised expectations of the long-awaited hike, what it means for the markets, and what factors will matter most once the Fed begins to normalize interest rates.

It's the Pace that Matters

Never in my career can I remember any event receiving as much coverage as the date of the Fed's first interest rate increase. It is almost impossible to imagine that the market has not already priced in the most debated rate hike in history. Markets rarely discount the same news twice, so I believe it is unlikely that there will be a strong market reaction once the Fed begins to raise rates. Figure 1 illustrates stock market performance under various tightening scenarios dating back to 1946. On average, stocks are up around 3% a year following the first hike during all tightening cycles.

Figure 1—Slower Fed Tightening Cycle Anticipated

S&P 500 Around Start of Fed Tightening Cycles Since 1946



Source: Ned Davis Research. Slow cases include: 4/25/46, 4/15/55, 9/12/58, 7/17/63 and 8/31/77.
Fast cases include: 11/20/67, 1/15/73, 9/4/87, 2/4/94, 6/30/99 and 6/30/04.

History also says that the pace of rate hikes matters. When the Fed exercises patience with its rate hikes, the market rewards amply with returns of around 11% on average one year after the Fed's first move. It is only when the Fed moves quickly that equity markets suffer, losing about 3% one year later. The data clearly show that the pace of the rate hikes, not the ultimate start date, influences the future return of the equity market.

Many Fed governors have conveyed that the pace of hikes will be slow and measured, but promises are one thing—following through is another. Inflation is the key variable that will have the most impact on the pace of future rate hikes, and for now, all signs point to continued low inflation. Two interrelated drivers of continued low inflation have been modest wage growth and the low velocity of money. While wage growth is beginning to exhibit some signs of strength, the velocity of money is not.

Year-over-year wages have steadily increased since the 2011 growth scare, but unlike prior cycles, wage growth has not yet been inflationary. One reason for this is because recent wage growth seems to have been pocketed by employees and not spent. This is evident in the relatively high savings rate of 5.6%—a level not seen at this point in an economic recovery in 20 years. High savings rates also influence the velocity of money, which is broadly defined as the average number of times a dollar is used to purchase a final product or service during a given time period. There are fewer transactions when individuals save instead of spend, leading to lower velocity of money. Low long-term real interest rates have also provided little competition to money market funds, CDs, and savings accounts. Rather than investing that money in longer-term bonds, which would have allowed that money to be recycled back into the economy more effectively and thus increase velocity, investors elected to hoard money in cash. Individual investors, in a sense, have been following in the footsteps of corporations, which have built large cash balances in order to be better prepared for future liquidity needs.

We will continue to monitor these two variables going forward. For now, it seems rising wages are being reserved for building war chests. While increased savings does not spur economic growth, it does tend to keep a lid on inflation in check, and that's good news if you're Janet Yellen.

On the Horizon

An aggressive Fed has a history of ending equity bull markets, and while the impending tightening cycle may end that way eventually, we believe that scenario may be years away. With the low-inflationary environment expected to continue, the Fed can be deliberate and patient in the frequency and magnitude of their rate hikes, allowing markets to adjust along the way. In the meantime, we have positioned client portfolios for gradually rising interest rates and do not anticipate major shifts in our asset allocation recommendations in the near future, even as the Fed begins to raise rates.

Humidity's impact on how hot we feel is much more important than the actual temperature as measured by a thermometer, even though it is usually the temperature that draws our attention in the weather forecast. In much the same manner, as others direct their attention to the timing of the Fed's first rake hike, we will strategically focus ours on the slope of hikes throughout the tightening cycle, for it is this variable that will determine how both equity and fixed income markets will react.

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