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Commentary

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"Will Markets Tumble When the Fed Raises Rates?"

Last month, the markets fell sharply after it was announced that the economy added over 200,000 jobs. Good news like that often sends the stock market into free-fall. Why? In this case it's because strong job growth might be seen as a green light for the Federal Open Market Committee ("The Fed") to raise interest rates, and that gives some people the jitters.

- **What the Fed Tries to Do:** The Fed's objectives for monetary policy are stable prices, maximum employment, and moderate long-term interest rates. According to Fed minutes, this equates to inflation of 2% (we are under 1.5%) and an unemployment rate of 5% to 5.2% (we're at 5.3%).

- **So, Why Change Interest Rates?** In simple terms, The Fed *lowers* interest rates to make it less expensive to borrow money. This entices people to spend more, thereby stimulating economic growth and job creation (because the economy is expanding). They might *increase* rates when the economy is growing already and the unemployment rate is near its target, but they have concerns about inflation. Higher rates mean tighter money, and tight money means less inflationary spending. Other factors apply and it's a delicate balance.

- **Where Does The Fed Want Rates?** Over the last 50 years, the Fed rate has been over 3.5% most of the time, and it's a shade over 0% right now. A majority of the Federal Open Market Committee participants expect rates to be between 3% and 4% by the end of 2017, and around 3.75% for the "longer run" (FOMC monetary overview).

- **Sometimes the Government Loses When Rates Go Up:** The Congressional Budget Office states that the government will have to pay as much as $2.75 trillion *more* in interest payment on U.S. government debt over the next 10 years if rates slowly rise to Fed target levels (see above).

- **Stocks Are Usually OK, Though:** Over the last 11 Fed tightening cycles (that's 3 interest rate hikes in a row or more), dating back to 1955, there has often been an initial market decline during the first three months after the hike. Within 6 months things tend to stabilize; and 12 months out in *slow tightening cycles* (what we expect this time) the markets have normally been up, averaging 10.8% (Source: Liz Ann Sonders, Schwab).

- **What Happens to Bonds?** Financial theory tells us that as interest rates rise, bond prices fall…so, bond investments ought to lose value. However, this is not always the case, and factors such as the starting level of rates (near zero now) and how fast and how much they rise impacts whether investors eek out gains or lose. Since bond returns are a product of price plus income, the income of a bond can cushion a fall in price. For the last three Fed tightening cycles, of 8 fixed income classes (e.g. Treasuries, high-yield, municipal bonds, etc.), 2 had gains during each cycle, and 3 were positive in 2 out of 3. The worst performance was the benign -3.21% of high-yield corporate bonds 6/1/1999 to 5/31/2000 (Nuveen, Barclay's).

The Fact is…No One Really Knows: If you were in a college statistics class and tried to draw conclusions from just 11 observations over a 60 year period—each with different external factors exerting influences—you'd be laughed out of class. This is analogous to forecasting stock and bond market reactions to coming Fed rate hikes. We can make inferences, and we may find some weak correlations, but *we cannot let interest rate hikes define our investment objectives and process*.

The lead up to, and eventual commencement of the newest round of Fed tightening has consumed far too much airtime and media space. It may not be "Deflategate", but it's close. There are other factors, such as China's growth trajectory, consumer sentiment, and corporate earnings which will have a greater impact on our markets. That being said, we'll keep an eye on Fed moves and will share with you our ideas to try to offset any risks. If you're not already a client, please give us a call and we'll be happy to share a few ideas with you.

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