Infomail
January 19, 2015

Res Ipsa Loquitur
(The Thing Speaks for Itself)
What Happens to Stocks and Bonds When the Fed Raises Rates?

"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten."
Bill Gates

We are getting closer and closer to the day of reckoning when the US Federal Reserve finally starts to raise interest rates. Most forecasts currently have the first increase scheduled for Q2 or Q3 of 2015. The recent volatility may be blamed on geopolitical events, or energy prices, or whatever, but I suspect markets are looking ahead and trying to figure out what to do about it. Historically, the markets look ahead 6-9 months and the six months before the first action have always been more volatile.

The knee-jerk reaction will be hastened by the way the Fed goes about its task. Right now, it seems central bankers globally are held hostage by markets who are like drug junkies in constant need of a stimulus "fix." If we take a look at the last round of Fed tightening, then Fed Chair Alan Greenspan took tiny steps. In the aftermath of 9/11 and the harsh recession of 2001-2002, Greenspan focused on housing as the tool to turn the economy around. What happened were temporary jobs were created for the later mother of all housing bubbles.

Exacerbating the situation further was how the housing market was being fuelled. Some mistakes which took place (with the benefit of hindsight):

- Approved and encouraged exotic mortgages that became toxic mortgages
- Overlooked massive regulatory issues and violations
- Kept rates too low for too long, and slowly inched them higher

Here's how the picture looked by the numbers:

Federal Reserve's "Slow Walk"

Year	Action	Rates at Year End
2003	Final rate cut June 25 bps	1.00
2004	Five rate hikes	2.25
2005	Eight rate hikes	4.25
2006	Four rate hikes	5.25

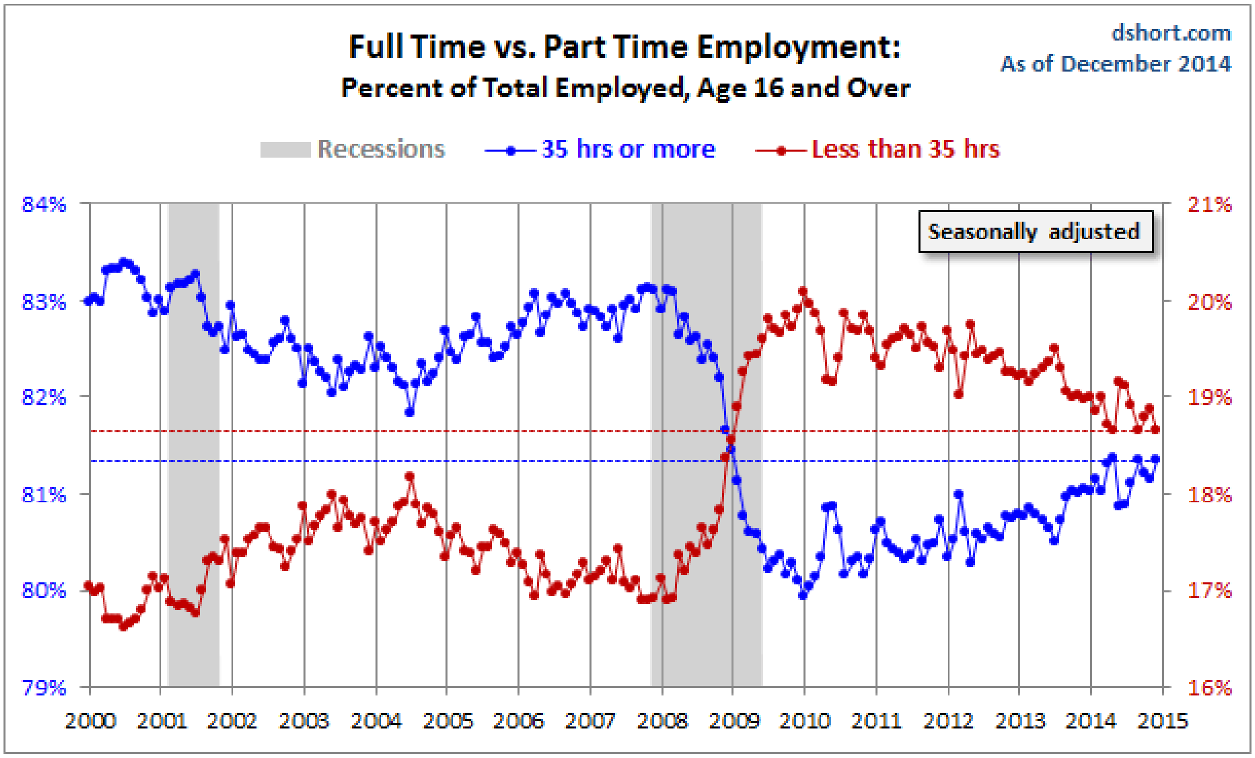
When Ben Bernanke took over mid cycle in early 2006, he also underestimated the impending danger from the housing market. Once the bubble burst, he began to act swiftly, and many would argue Quantitative Easing (QE) created more harm than a worst-case scenario meltdown.

If you recall, recently there was immense fear when the Fed announced it would remove QE that the stock markets would crumble. On the contrary, the markets moved much higher and interest rates actually went lower. Now we hear the pundits talk the same calamity should the Fed begin to raise rates.

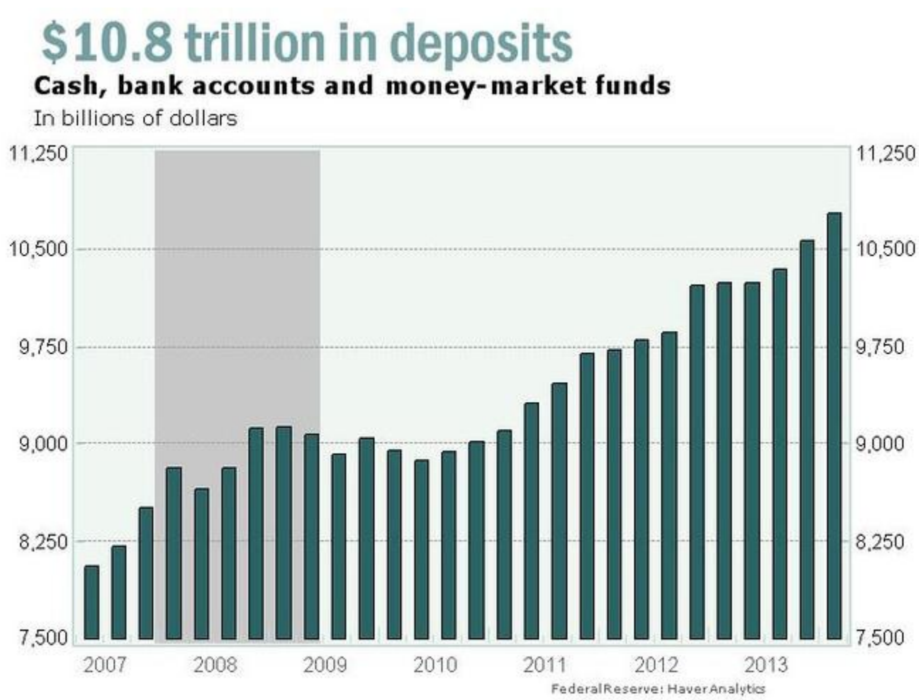
But despite an estimated over $7 trillion (yes, trillion) in global stimulative programs by central bankers, global economies stagger along barely above stall speed. Talk about pushing on a string. US growth is outpacing that of Japan and Europe primarily because those economies carry much higher debt-to-GDP. Based on available data, aggregate debt in the USA stands at 334% of GDP, compared with 460% in 17 economies in the euro-currency zone, and 655% in Japan.

And for that reason, I believe interest rates may stay lower for longer than many believe.

Not only can many countries debt levels not sustain interest costs, the economic pace of growth remains anemic and technological change continues to put a cap on job and wage growth. If the latter is especially true, employment may not return to previous peaks any time soon (i.e. Hurdles holding back the labour market may be <u>structural</u> rather than <u>cyclical</u> and will then require <u>fiscal</u>, rather than <u>monetary</u> solutions). Without real job and wage growth, the Fed will most likely continue to err on the side of caution. In addition, the <u>composition</u> of created jobs shows more part time than full time work. In 1968, part time jobs comprised only 13.5% of total employment; the number peaked at 20.1% in 2010, and stands currently at 19.2%.



While the Fed playbook with its QE's et al has been to print money, make people feel richer and get people to spend more, instead, since QE2 began, people have plowed $1.2 trillion into bank accounts, bringing the grand total to $10.8 trillion of 84.5% of annual disposable income, which is the highest ratio in 23 years.

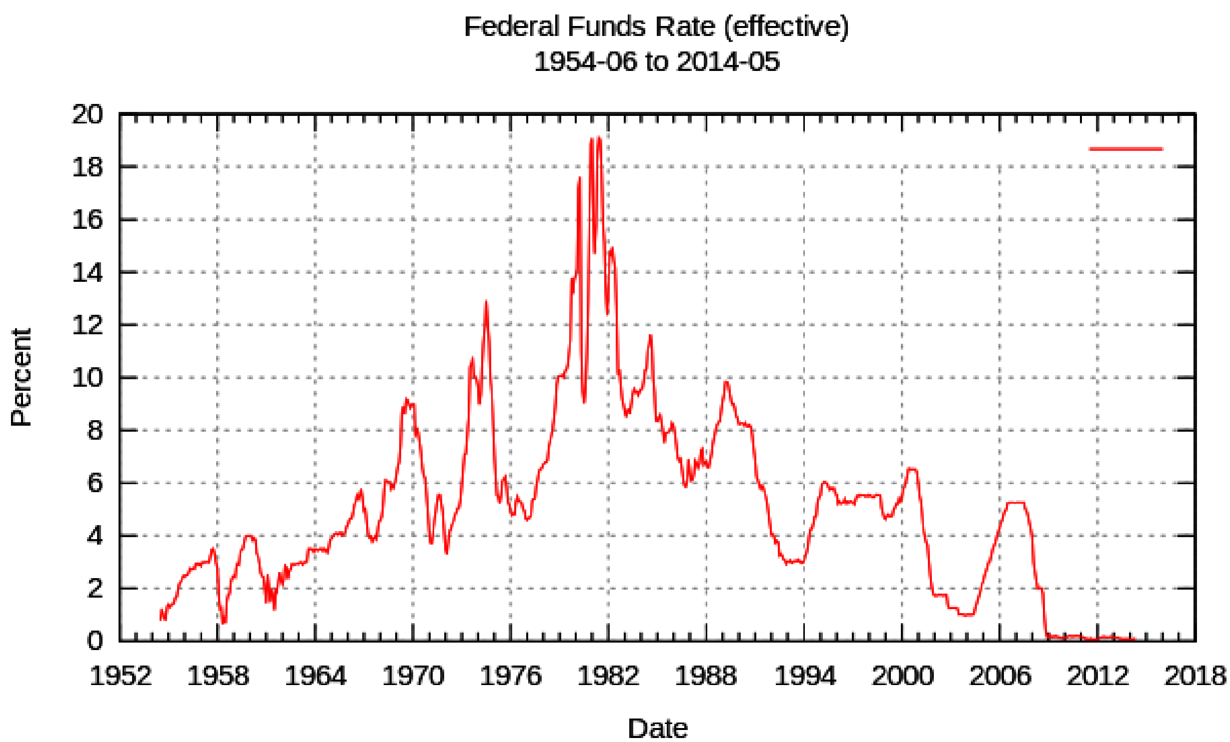


Interest rates have been falling for 35 years, but too many people seem to be in a hurry to pick a bottom in rates. Of course rates will rise eventually, they are zero, don't have to be a genius to figure that out. Rates have been zero in Japan since the 1990's, so just because rates may rise in the US, doesn't mean the bottoming process couldn't take 10-15 years to play out. Long interest rates have continued to fall so far in 2015, the 10 year US Treasury hit 1.74% last week, but when the 10 year German bund is at about 0.75%, and the Japanese 10 year at about 0.25%, maybe it goes lower? Money is flowing into US bonds looking for yield not available elsewhere, plus combine that with a rising US dollar, so money continues to flow to the US bond market.

So what happens to stocks and bonds when the Fed raises interest rates?

Because interest rates play such an important role in the economy and markets, investors should be concerned as to what happens when the Fed finally makes its move.

Here's what the Fed Funds Rate (the short term interest rate set by the Federal Reserve) looks like going back to the mid 1950's:



As one can easily see, the Fed has raised rates on many occasions in the past, so we can see what the impact has been on markets:

	Total Return	
Fed Funds Rate Rising	Stocks	Bonds
May 1958 - November 1959	41.4%	-4.2%
July 1961 - November 1966	47.5%	16.4%
July 1967 - August 1969	12.7%	-1.6%
March 1971 - August 1971	-5.2%	-1.3%
February 1972 - July 1974	-17.4%	-2.5%
January 1977 - May 1980	12.2%	-15.5%
July 1980 - June 1981	20.7%	-12.4%
February 1983 - August 1984	23.0%	11.2%
June 1985 - December 1985	14.1%	15.4%
October 1986 - September 1987	43.4%	-3.2%
March 1988 - March 1989	14.5%	5.2%
December 1993 - April 1995	15.8%	2.8%
June 1999 - July 2000	11.5%	1.7%
December 2003 - July 2007	46.9%	17.8%
Average	20.1%	2.1%

The track record for equities is pretty good. In 14 occasions of rising rates since 1955, stock investor's made money in 12 of 14 cycles for an average of 20.1%. Bond investors lost money half of the time (7 of 14), but returns averaged only 2.1%.

Now after the fed stopped raising rates, looking out 1, 3 and 5 years:

	Plus 1 year		Plus 3 years		Plus 5 years	
Fed Funds Rate Rising	Stocks	Bonds	Stocks	Bonds	Stocks	Bonds
May 1958 - November 1959	-1.3%	6.9%	5.6%	6.8%	11.2%	5.3%
July 1961 - November 1966	20.7%	-4.3%	8.6%	-2.5%	6.6%	3.3%
July 1967 - August 1969	-11.4%	-0.3%	8.7%	8.0%	-2.3%	2.9%
March 1971 - August 1971	15.5%	7.8%	-7.1%	-0.4%	4.5%	6.4%
February 1972 - July 1974	17.2%	17.1%	12.2%	14.3%	10.5%	9.6%
January 1977 - May 1980	31.3%	-10.0%	21.9%	15.0%	16.7%	12.4%
July 1980 - June 1981	-11.6%	7.7%	10.7%	13.5%	19.2%	21.2%
February 1983 - August 1984	18.1%	29.9%	33.2%	20.5%	19.5%	16.8%
June 1985 - December 1985	18.6%	19.8%	12.0%	9.8%	12.4%	10.4%
October 1986 - September 1987	-15.4%	18.6%	0.7%	12.1%	8.3%	14.1%
March 1988 - March 1989	19.3%	12.2%	14.9%	13.1%	12.1%	11.6%
December 1993 - April 1995	30.2%	9.9%	32.0%	11.2%	25.3%	6.9%
June 1999 - July 2000	-14.3%	17.5%	-10.2%	11.0%	-1.4%	10.9%
December 2003 - July 2007	-11.1%	0.0%	-8.7%	10.8%	1.1%	11.9%
Average	7.6%	9.5%	9.6%	10.2%	10.3%	10.3%

**Returns Annualized*

On average, things are nowhere near where the pundits would like investors to believe. Sure, there are lots of variables which can affect any cycle like valuations, trends, sentiment, etc…

So sometime in 2015, odds are pretty good we get the first Fed interest rate increase in sometime. Markets will have an awkward period going into it and no doubt the initial knee jerk reaction will create some volatility, but I still believe that given the current global economic scenario, interest rate increases may come slower than expected and rates may still stay lower than many forecasters currently are looking at.

If that holds true, it may help equities extend their gains in this bull market.

Stay tuned,

Vito Finucci
Vice President and Director
Investment Advisor