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As I have reviewed client portfolios over the preceding quarter the over-riding message I'm getting is a mix of pleasure and relief. Surprise -the past few years have, by and large, been a great time to be an equity investor (as long as one had a healthy measure of U.S. exposure in portfolios and was not over-weight Canadian resource stocks). I'm even detecting a small measure of rate-of-return complacency creeping into some discussions.

Of course, despite the markets' recent strong numbers, a number of questions are surfacing about the year ahead.

Top of the list is the effect that rising U.S. interest rates will have on both the economy and markets. Like any big anticipated event, ask two experts what the outcome will be and you will often get two wildly divergent views. Some believe that rising U.S. rates will be the end of the party and the trigger for a huge market pullback. Others are equally certain that interest rate increases are already built into market expectations and it will be "business as usual" going forward.

As your self-appointed voice of moderation, I suspect that reality will be somewhere in the middle. On one hand, there is no doubt that the U.S. Federal Reserve's zero interest rate policy and Quantitative Easing programs have been a huge tailwind for the stock markets. On the other hand, the Fed has been very clear that rate increases are coming SOON and the markets understand this completely. The only question is in

"what month" will the first rate increase occur and how measured the pace of future increases will be.

It's that last point that is the key to the discussion. It's likely that any rate increases in the U.S. will be modest and measured. Yes, the U.S. economy is healthy and unemployment has come down dramatically since the recession. But the U.S. economy is far from over-heating (the usual reason that central banks aggressively increase rates).

Inflation is still quite low. Increased employment has not translated into higher wage demands (which drive inflation). Low energy prices seem to be here for some time (another traditional source of inflationary pressure) and a very strong U.S. dollar means that the price of imported goods is actually falling for U.S. consumers.

Yet any rate increase will be a slight negative for the stock and bond markets (except perhaps for bank and insurance companies, which typically do better in a slowly rising rate environment).

That's because investing is all about relative valuations. If the risk-free rate is 0%, riskier investments like equities are simply more valuable than if the risk-free rate was, say, 2%. That tells me that equities will likely remain attractive for some time to come – just a little less attractive than they were over the past few years.



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