viewpoint

MARSHALL & SULLIVAN

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Preparing for Rising Interest Rates

It has been over six years since the Federal Reserve lowered interest rates to 0%. This is the first time in Fed history that rates have held this low for this long. Many positives have happened during this period:

- Unemployment rates have been nearly cut in half.
- A growing economy with the recession well behind us.
- A recovering financial sector.
- Diminished personal debt levels.
- Nearly all US stock market averages at or near historical highs.

The major negative has been for individuals that are trying to live on the interest from their investments. Low interest rates have limited their income.

The Federal Reserve's mandate of maximum employment, stable prices, and moderate long-term interest rates is well on its way to being achieved. This leads to the question of when will the Federal Reserve start raising rates. The idea being that if rates are too low for too long, inflation will pick up and the goals of the Fed mandate will be unobtainable.

Pundits have searched for clues to help them ascertain when rates will raise by dissecting every word written or spoken by members of the Federal Reserve Board. In their most recent policy statement, the Board stated many of the same things they have said for the past few years, with one exception: the removal the word "patient" from the following sentence: *"Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy*." Removing this word set financial news on fire as pundits now felt a sign had been given that the date is near. Discussions about whether rates will raise after the June or September meeting followed despite the fact that the Fed does not need to wait for a meeting in order to begin their rate increases.

There are many factors outside the Federal Reserve's control that affect the Federal Reserve's mandate. An example of this is the recent interest rate decrease initiated by the European Central Bank. Their lowering of rates makes the US dollar stronger. A stronger dollar makes exports more expensive. This ultimately hurts US employment.

In general, Marshall & Sullivan does not spend a lot of time focusing on when interest rates will rise. More importantly, we look at how raising rates will affect the economy and its impact on corporate earnings growth. We then position our portfolios accordingly.

To position our bond portfolios for rising interest rates, we have been purchasing shorter term bonds. This will allow us to take advantage of higher rates in the future and will protect our fixed income investments from losing value as rates increase. Currently, our fixed income portfolios will have half of their investment mature in the next two years.

Historically, as long as the economy has continued to do well, so has the US stock market. Looking at other periods of interest rate increases is one way to judge how the economy might respond. Normally, the economy has done well for the first few years after the first rate increase and then starts to slow and move into a recession. As a leading indicator, it is likely that the equity markets will start to slide a little before the economy does.

Of course, all equities will not be treated equally. Companies with large dividends will tend to act more like fixed income vehicles unless they are able to grow their earnings and thus there dividends. In this environment, Marshall & Sullivan will maintain its focus on stocks with continued earnings growth and remain vigilant to look for signs of a weakening economy.

This is not to say that the market will not have a pull back when the Federal Reserve raises rates. If they do, Marshall & Sullivan will use some of the cash in our portfolios to take advantage of the pullback. Because everyone is so focused on interest rates, we think that it will not be a surprise when rates finally do rise. The markets are likely to take it all in stride and recover quickly.

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