viewpoint

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The Fed Finally Raises Rates

As most of our readers are aware, on December 16th, the Federal Reserve finally lifted the Fed Funds rate above zero after holding it there for almost 7 years. They had lowered the rate to help the economy recover from the 2007-2008 financial crisis. With the economy growing, pundits have been predicting – even, arguing about – the timing of the rate increase and its expected effects on the markets for several years.

Markets are forward looking, so we started to see the effects of rising rates even before the Federal Reserve actions. Most of the affect has been in commodities and currency markets. For example Oil has not been this low since 2004 and gold is hitting multi-year lows. The dollar has done the reverse. It has strengthened against all currencies. This trend should continue with the Federal Reserve projected to slowly raise rates over the next few years as the economy continues it slow growth.

What is interesting about the Federal Reserve's rise in rates, is how it has affected interest rates on bonds. As expected, short-term yields have increased. Conversely, the 5 and 10 year treasury instruments are yielding about the same today as they were a year ago. This suggests that the rise in rates did not affect the long-term outlook for the economy or inflation. If the Federal Reserve continues to raise rates, as they have intimated, we should see longer rates move up in the future.

For our clients holding bonds, the Federal Reserve's rise in the federal funds rate has been a bit of a non-event. Over the last few years we have been shortening up our maturities in anticipation of rates going up. With yields unchanged on 5 and 10 year bonds and the Federal Reserve expected to slowly raise rates, we will continue to keep our portfolios short-term. The good news is that as current bond holdings mature, we are likely to reinvest the proceeds into fixed income securities with better yields.

When it comes to equity markets, we normally focus on the economy, earnings, and occasionally emotions. In our view, this is much more important than a small rise in short-term interest rates. When looking at international markets you need to add currencies to the mix. Small moves in currencies can be overcome by earnings growth. With the US dollar up 8% or more this year, international equity markets are down. The U.S. dollar went up much more verses emerging markets currencies then developed markets currencies so companies in established economies went down much less than companies in emerging markets. In 2015, the MSCI EAFE index (developed equity markets) was down over 3% and the MSCI Emerging Market index was down over 18%.

The S&P 500 and Dow Jones Industrial average were both flat for the 2015 and since the Federal Reserve announcement. The average company in the S&P 500 grew its earnings at less than 1% in 2015. With earnings barely growing and the S&P500 flat it would seem that the rise in rates was a non-event.

It becomes an event when one breaks down the S&P 500 into sectors. Companies that relied on the price of commodities and doing an overwhelming amount of their sales outside the U.S. did poorly. A great example of companies relying on commodities are diversified oil companies. Exxon Mobil saw its earning fall 48% this year and Chevron's fell over 64%.

Going forward we will continue to focus on fairly valued companies with the potential to grow their earnings. This means we will avoid commodity based companies. Currently the average company in S&P 500 is projected to grow its earnings at 7%. In our portfolios the average projected growth rate is 8%.

Markets will probably stay as volatile in 2016 as they were in 2015. The first trading day of the New Year is clear evidence of continued volatility. However, we think the market will break out of its current trading range as earnings resume their growth and the economy continues to trudge along. We will use any cash that builds in our portfolios to purchase new names that fit our strict buy disciplines and sell companies that cannot continue to grow their earnings in this slow growth economy. We see no reason to change our asset allocation at this time.

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