INVESTMENT STRATEGY GROUP

FROM THE DESK

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INVESTMENT IMPLICATIONS OF HIGHER INTEREST RATES

The Federal Reserve (Fed) raised short-term interest rates today for the first time in almost ten years at the conclusion of its two-day policy meeting. This small initial increase of 0.25% comes after maintaining a zero interest rate policy since the financial crisis. We would stress the following points after this historical move off of the zero-bound.

The Fed is Displaying Confidence in the US Economy: Since the financial crisis, the Fed's zero interest rate policy has helped restore health to the economy and labor markets. While there are still concerns about under-employment and a low participation rate, headline unemployment now stands at 5.0% (down from over 10% in the aftermath of the Great Recession) while job openings are at historically high levels.

This healthy labor market puts the Fed much closer to its major mandate of full employment and suggests very low interest rates are no longer required to help support economic growth. We also anticipate further US and global economic growth in 2016 that should boost corporate profits and further stock market gains.

S&P 500 Performance Before/After First Fed Rate Hike

	BEFORE First Hike			AFTER First Hike		
Date	13w	26w	52w	13w	26w	52w
Apr-55	8%	20%	36%	12%	9%	26%
May-58	5%	8%	-6%	9%	17%	32%
Jul-63	-1%	5%	20%	7%	12%	23%
Nov-67	1%	3%	16%	-3%	3%	13%
Jul-71	-4%	7%	28%	-1%	4%	8%
Jan-73	9%	11%	15%	-6%	-10%	-20%
Sep-77	0%	-4%	-7%	-3%	-10%	6%
Sep-80	9%	25%	16%	8%	7%	-11%
Feb-84	-1%	-1%	10%	-1%	1%	11%
Sep-87	8%	9%	26%	-29%	-16%	-16%
Feb-94	2%	5%	5%	-5%	-3%	2%
Mar-97	2%	13%	20%	15%	22%	42%
Jul-99	8%	13%	21%	-8%	6%	5%
Jul-04	-1%	2%	14%	1%	8%	6%
AVERAGE	3%	8%	15%	0%	4%	9%
ALL PERIOD AVG	*2%*	*4%*	*9%*	*2%*	*4%*	*9%*

Source: Oppenheimer

While we may experience further near-term stock market volatility as the Fed normalizes interest rates, we continue to favor stocks over bonds and cash as we move into 2016.

The table shows stock market performance around the first Fed rate hike dating back to 1955. The market is up 9%, on average, one year after the first hike and exhibits positive returns about 80% of the time.

US Consumer Remains a Major Investment Theme: The improvements in the economy and labor market have allowed the US consumer to reduce debt, regain confidence, and increase net worth and purchasing power. This has benefited consumer facing economic sectors which remain among our favorites.

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We prefer the Consumer Staples, Health Care and Financial sectors which are all benefitting from a healthy consumer. Many financials will also benefit from the move away from zero short-term interest rates. Homebuilders will continue to benefit from a healthy consumer, pent-up demand, and still low interest rates.

We also see opportunities in high yielding, defensive sectors that have underperformed in anticipation of the Fed's interest rate normalization, despite the potential for further volatility. These include select Telecoms and Utilities.

We would continue to avoid deep cyclical sectors with significant commodity and emerging market exposure (more on this below). These include many Industrial and Material sector stocks.

Favor Developed Stock Markets that are Earlier in the Business Cycle: Stocks prefer easy monetary policy and strong profit growth. Europe and Japan continue to pursue ultra-easy monetary policies and should see stronger profit growth in 2016 relative to US stocks.

Europe's economic recovery continues while the European Central Bank is pursuing ultra-easy monetary policy for the foreseeable future. European corporate profitability also has significant room for expansion. Japanese stocks have valuation support and should benefit from further global economic growth and a weak currency.

Ramifications of Further Dollar Strength: The dollar has strengthened substantially relative to other currencies in anticipation of higher US interest rates. This dollar strength has influenced many markets including emerging markets, commodities, and the translation of international stock returns into US dollars. We see further dollar strength ahead and remain concerned about the following asset classes:

Continue to Underweight Most Emerging Markets: Many emerging markets are over-indebted and in need of structural reform. Meanwhile, a strong dollar can manifest itself as higher inflation and interest rates, tougher debt refinancing conditions, and ultimately, in capital flight for many EM countries. We would avoid countries that are heavily dependent on commodity exports including Brazil, Russia, and South Africa. We would stick with the countries that benefit from lower commodity prices and are pursuing economic reforms which include China, Mexico and India.

Commodities Inverse Dollar Correlation and the End of the Commodity Super-Cycle: Commodities exhibit a strong inverse correlation with the dollar and further dollar strength implies more commodity weakness. As China's growth rate cooled, so did their insatiable demand for commodities. Meanwhile, supply of many commodities significantly increased about the same time, including many industrial metals and energy. This spelled the end of the commodity super-cycle which has been aggravated by dollar strength. We see further weakness in 2016.

In sum, while this begins the journey toward interest rate normalization, we expect it to be a slow one. As a result, equity markets should respond more to the positive economic underpinnings – a catalyst for profit growth – and less to monetary policy.

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