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Fed Watching 2015

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After much speculation by investors and "Fed watchers," the Federal Reserve (the Fed) decided last week not to raise policy rates. We think the first Fed move will occur in December after significant warning by the Fed, and therefore the most important question for investors is the timing and size of the increases after the initial hike.

The Fed stands pat…
The Fed signaled greater concern regarding the financial market and international developments in its post-meeting statement: "Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term."[1] The statement also noted the Federal Open Market Committee is "monitoring developments abroad."

…with significant headwinds to future rate increases.
While US economic growth has been respectable and the labor market has continued to improve (with unemployment now at 5.1%), wage growth remains modest and inflation stands well below the target level of 2% (for August 2015, year-over-year core CPI was 1.8%; however, headline CPI, which includes food and energy, was up just 0.2%).[2,3] Further, general financial conditions (measured by, for example, a stronger US dollar, lower stock prices and wider credit spreads) have tightened sharply since August. According to a recent Goldman Sachs estimate, if current conditions persist, it would be equivalent to roughly three hikes in the Fed Funds rate.[4]

Now the most important question is the timing and size of future increases.
Even with the financial markets effectively hiking rates, we think the first Fed move will likely occur in December, absent significant market events or a drastic slowdown in the US economy, and as long as such a move is well-anticipated by the market. We feel there will be significant warning from the Fed prior to a rate hike.

If that's true, the most important question for investors becomes the timing and size of the increases after the initial hike. Historically, periods of rate increases were short, with large moves – the Fed was acting to slow down an overheated economy. The last cycle (from 2004 to 2006) was different, with a long period of small, well-previewed increases. Since the current environment is most like 2004 (see Figure 1), we think the Fed will behave in a similar manner.

Figure 1. Periods of Fed Funds rate hikes.

	Period 1 2/4/1994 - 2/1/1995	Period 2 6/30/1999 - 5/16/2000	Period 3 6/30/2004 - 6/29/2006	Current as of 9/15/2015
Starting Fed Funds Target Rate (%)	3.00%	4.75%	1.00%	0.00-0.25%
Number of Hikes	7	6	17	TBD
Total Increase (%)	3.00%	1.75%	4.25%	TBD
Duration	12 months	10 months	24 months	TBD
Yield Curve Steepness (%)	1.95%	1.40%	2.92%	2.71%
Other Economic Variables	• Economy expanding above trend, inflation rising • Pre-emptive tightening	• Strong economy, full employment, inflationary concerns • Pre-emptive tightening	• Low inflation, trend-like growth • Removal of loose policy at a measured pace	• Low inflation, trend-like growth • Expected to be removal of loose policy at a measured pace

As of 9/15/15. Sources: Thompson Reuters MMD, Nuveen. Data shown applies to the time period listed in the table. The Federal Reserve has not yet raised rates so the current period is hypothetical. Yield curve steepness refers to the difference between the Municipal Market Data (MMD) 2- and 30-year yields.

Focus on fundamentals

We think advisors should avoid sensationalized media portrayals and simply listen to the Fed—Janet Yellen won't keep us guessing. Advisors should not focus on the timing of the first increase, but rather on the path of rates over the next several years, which we think will be flat.

There are some investment implications. Yields in most fixed income assets have been at or close to their quarter-century lows, supported by easy central bank policy, weak growth and low inflation expectations. Low interest rates and low expected returns for equity markets has supported a preference for equity yield, particularly among US investors looking for a seemingly lower risk way of getting back into the equity market. With investors focusing on Real Estate and high-dividend sectors in the equity market, the relative performance of these "bond proxy" equity sectors has been closely correlated with changes in government bond yields.

But as the first rate hike nears and the growth picture in the U.S. stabilizes further, this preference for equity yield faces a headwind. In the equity markets, we continue to recommend companies offering both high dividend yields and share buyback programs, supported by strong cash flow. Finally, in the bond markets, we seek opportunities in sectors that are not highly correlated with US Treasuries, such as high yield municipal bonds.

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1. *Federal Open Market Committee, press release, September 17, 2015.*
2. *Data as of August 2015. Bureau of Labor Statistics.*
3. *Bureau of Labor Statistics, "Consumer Price Index Summary," September 16, 2015.*
4. *Goldman Sachs, "US Daily: The Markets Have Already Done Much of the Fed's Dirty Work," September 10, 2015.*

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