HIGHER INTEREST RATES? GOOD NEWS!

As the Fed moves closer to the start of its first interest-rate tightening cycle in nearly a decade, most investors are hoping for the best as they brace for a brand new market environment. Unfortunately, the stock market is illogical and driven by human emotion, greed, fear and TV pundits. Market experts are unsure how the equity markets will interpret an interest-rate rise, however, I'm sure investors and many managers will overreact as usual.

At WT Wealth Management we examine empirical data, along with historical data, and believe we will see a relatively smooth transition into a Fed tightening cycle. For starters, and people easily forget this, raising short-term interest rates means the Federal Open Market Committee (FOMC) believes the economy is strong enough to absorb an increase in borrowing costs, which should be interpreted as positive economic news.

Supporting the "things are getting better story" has been the upward revisions in Gross Domestic Product (GDP) in the second quarter from the initially reported 4.0% to 4.2% (the 2nd revision) and finally 4.6% (the 3rd and final revision). The last revision was preceded by another milestone, when the S&P 500 Index closed above 2,000 for the first time and made multiple new highs. Good news continued after the last GDP revision and on October 3rd, we reached the lowest unemployment rate in 6 years with the unemployment rate falling below 6% for the first time since 2008.

Based on GDP, unemployment and inflation targets set by the Fed, the economy is nearing the "healthy enough" point to handle a nominal move off the current floor of near-zero short-term interest rates, but there is still wide speculation as to when and how the Fed will start to take action. The U.S. economy, however, is still in unprecedented territory as it winds down six years of record-level quantitative easing, leaving the Federal Reserve with a $5 trillion balance sheet of Treasury and mortgage backed bonds.

If we continue to receive positive economic reports, we believe that Fed Chair Janet Yellen is going to have to move up her time table for raising rates, or else the Fed will be behind the curve. The consensus among market watchers is that Ms. Yellen will likely start raising rates at some point during the middle to last-half of next year, and we believe the equity markets are currently prepared for that time period but an earlier move could be seen if economic news continues to be positive.

A rate hike in June of 2015 is already factored in, the markets tend to adjust to the consensus, but if a rate increase happens earlier many feel that investors will be taken by surprise. At WT Wealth Management we firmly believe the FOMC will openly communicate its intentions well before any move in interest rates. In our opinion, investors will not be given a surprise.

In terms of portfolio allocations in the face of rate hikes, history shows that staying put has been the most prudent and appropriate strategy. After analyzing interest rate hike periods since 1923, we have found that initial market drops are to be expected, but investors who do not panic and stay on course are usually rewarded.

Our study of 16 rate hike periods, over the past 91 years, where interest rates rose the most, found that the average performance of the S&P 500 during the first month was a decline of 78 basis points or ¾ of 1%. However, the median return for periods ending 12 months later, were 11.5%. Remember, if the FOMC raises rates, the economy is getting better. If you needed any more convincing that higher rates are a good thing, we complied our research into 2 tables. The first table highlights the 16 periods since 1923 when rates rose the most in a 12 month period. When reviewing the subsequent returns of the S&P 500 in only 3 of the 16 tightening cycles did the S&P 500 fall during that 12 month period.

S&P 500 returns for twelve-month long periods during economic expansions when interest rates rose the most

12 month period ending	S&P 500 return in %
05/31/2004	18.33
10/31/1994	3.87
05/31/1984	-3.12
07/31/1981	12.85
01/31/1980	20.85
07/31/1973	3.70
09/30/1969	-6.44
05/31/1959	37.62
07/31/1957	0.76
06/30/1953	2.35
08/31/1948	10.15
05/31/1940	-15.89
04/30/1937	24.39
03/31/1929	38.37
10/31/1925	39.61
04/30/1923	15.05

Covers 12-month long time periods that ended form 02/29/1920 through 07/03/2013

The second table consolidates the results from the above research. Over the 16 periods there was an 81% chance that the return of the S & P 500 would be positive vs 73% for all the possible 12 month periods in this 91 year study. In addition, the mean return was 12.62% and the median return was 11.5%.

Summary results for twelve-month long periods of greatest interest rate increase

	S&P 500 returns in % for	
Statistics	Twelve-month long periods during economic expansions when Interest rates rose the most	All possible twelve-month long periods
Median return in %	11.50	12.94
Medan return in %	1262	12.09
Frequency (probability) that the return was positive (>0.0%)	81	73
Total number of twelve-month periods	16	1122

Covers 12-month long time periods that ended form 02/29/1920 through 07/03/2013

The translation from the above tables, don't worry about higher rates, embrace them.

In terms of timing, there is a minority camp that thinks the Fed should raise rates sooner. In any cycle there are always "hawks and doves" and I firmly believe that the Federal Reserve will err on the side of caution and move later rather than sooner. It would be devastating to the American psyche if a rise in rates triggered another economic set-back. The last thing anyone wants is QE4. The bond market seems very comfortable with what the Fed is doing at the moment, but that validation can dissipate very quickly.

Along those lines, the Fed is getting points for transparency by trying to avoid surprising the financial markets. As one noted economist recently said "I don't really think the equity markets are that vulnerable to higher rates because we've been talking about higher rates for years."

At WT Wealth Management we are prepared for the Fed to raise rates. As you now know, raising rates is a very positive sign for the economy, even though there will be some noise in the markets the first time they do it. It will be a clear signal that the troubling years of 2008 and 2009 are behind us and American can look forward to more "normal" times. Who isn't looking forward to that?!

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