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Polaris Educational Series

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When Will The Feds Raise Rates?

(and what is the impact on my portfolio?)

The Federal Open Market Committee (the FOMC) announced on April 29th that it would keep target interest rates at "near zero" levels. The FOMC also removed all hints at a timeline in which it may start raising rates. Currently, the Federal Reserve is keeping rates between 0% and 0.25%, where they have been since late 2008. According to the CME Group, there is almost a 60% chance of seeing a rate hike by the end of the year and over an 80% chance of a move by March 2016.

I agree that the FOMC will likely raise rates in the next year. It can't keep rates at 0% forever. The government ended quantitative easing in the fall of 2014, and our economy has not been negatively affected. It would be a natural "next move" in the FOMC playbook to see if it can raise rates. Once the FOMC raises rates, expect at least one additional rate hike. Historically, when the FOMC has made a change to the fed fund rate (up or down) rates have moved at least one additional time in the same direction. The first move will most likely only be 25 basis points. The FOMC will test the waters. As long as the economy doesn't go into a free fall, it will raise rates again within six months. That said, I don't see the FOMC moving rates aggressively. Here's why.

1. We Can't Afford It:

A change in the fed funds rate will make issuing debt more expensive. This has a direct impact on our government's debt and deficit. According to the U.S. Treasury, 70% of our government debt will mature within five years. As it matures, the government will issue new debt to replace it. If rates increase significantly, it will cost more to pay for this newly issued debt. Currently, it costs our government $300 billion a year in interest payments to service our debt. This is part of the $500 billion deficit our country currently runs. Any increase in the fed funds rate will increase these annual payments and thus impact our annual deficit.

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2. The Dollar Is Too Strong:

The dollar has been strengthening substantially over the past year. This is due, in large part, to the European Central Bank and the Bank of Japan's attempt to stimulate their own economies with quantitative easing programs. On May 6, 2014, one euro was worth $1.39. It has dropped to $1.12 as I write this report on April 30, 2015. That's a drop of almost 20%. The dollar has also strengthened almost 20% to the Japanese yen and over 10% to the British pound. An increase in the fed funds rate would further strengthen the dollar, making U.S. products more expensive to buy abroad. The strength of the dollar has already impacted corporate earnings, especially for U.S. companies that have significant revenue coming from sources abroad. It could continue to impact earnings if the dollar continues to strengthen.

3. The Economy Isn't That Strong:

Raising interest rates is the main way that the government can slow the economy and control inflation. At the moment the U.S. economy is chugging along slowly. Some economic figures have been strong while others have been mediocre at best. Any significant rise in the fed funds rate could slow the economy to near zero growth or put our economy into a recession. The FOMC is very aware of this risk and will monitor it closely.

4. There Aren't Signs of Inflation:

According to the Bureau of Labor Statistics report published on April 17, 2015, inflation was -0.1% over the prior 12 months, ending on March 31st. This means that the United States experienced no inflation in the past year. Over the last several years the Consumer Price Index has increased at very low levels (0.8% in 2014, 1.5% in 2013, and 1.7% in 2012). If we don't have inflation, why raise rates to combat it?

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It is inevitable that we will see the FOMC increase the fed funds rate. It is unrealistic to expect rates to remain at zero percent forever. What will the impact be to you and your total portfolio when rates do rise? What direct impact will this move have on you personally? Let me summarize the impact.

1. There Will Be Pressure On Real Estate Prices

This is simple economics. When interest rates rise, mortgage rates go up. The more one is paying to carry debt, the less affordable real estate becomes for the buyer. Real estate prices typically drop to offset some of this increased cost. Obviously this is a major generalization. I do realize that not all real estate is the same. For example, more expensive homes are typically not as impacted by interest rate movements because the people buying these homes spend a lower percentage of their disposable income on their monthly mortgage bill. Geographic constraints can also materially impact real estate prices. Historically, rising interest rates impact real estate prices.

2. Some REITs Will Perform Well

Real Estate Investment Trusts invest in a variety of different types of real estate. If the FOMC raises rates, it will do so based upon the belief that the economy is strong enough to take it. That most likely means that there has been further job growth. This will be good for commercial real estate. With higher employment, consumers will have more money to spend. This will be good for REITs invested in retail space. Also, REITs that invest in apartment buildings will have more demand as the worst buyers become the best renters. However, other types of REITs will be impacted by the higher "cost to carry" of real estate.

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3. Most Bonds Will Fall In Price

There is an inverted relationship between interest rates and bond prices. Think of it like a see-saw. As rates rise, prices drop. The further out you are (the longer the maturity of your bond), the more the price will drop. Short-term bonds should perform fine.

4. Expect More Volatility

Our days of below average volatility may be nearing an end. Investors do not like uncertainty. A rising interest rate environment is anything but certain. There is a phrase in our business, “financial history never repeats itself exactly, but it does rhyme.” I would expect a lot of rhyming.

5. Stocks Should Perform Fine Over The Long-term

There have been many studies done on the impact the decisions made by the FOMC have on the stock market. Depending on the measurement period and how the FOMC’s policy is defined, stocks have performed just fine during rising interest rate environments, gaining between 8% and 10% annually (depending on the study). Often times the markets drop at the rumor of interest rate hikes and continue to fall after the first hike. Then they quickly recover from these losses. The best returns in the stock market have occurred when rates have risen gradually, which is what the FOMC has been discussing.

6. This Will Be A Sector Driven Market

Historically, sectors like technology and energy are good places to invest during a rising interest rate environment. Interest rate sensitive sectors like financials, utilities, and telecom are areas to eliminate or trim.

7. Commodities Will Continue to Drop

A rising interest rate environment is very bad for commodity prices. Gold and interest rates have historically had an inverse relationship. The FOMC will raise rates to slow economic growth, thus dampening demand for commodities.

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As you know, our dedicated Investment Team is constantly evaluating the risk in the markets and each of the holdings in your portfolio. Our tactical strategies are designed to manage your risk and move your holdings to areas of strength in the market as they appear.

I strongly encourage you to consult your wealth adviser at Polaris to discuss holdings that you may have away from Polaris so we can assess their risk. We can also assess your financial situation and how rising interest rates may impact your finances. We are confident that we will be able to successfully navigate this ever changing environment and help you accomplish your long-term goals.

I hope you enjoyed this e-mail. Please feel free to share it with anyone that you feel may benefit from Polaris' service.

As always, I welcome your comments and questions.

Sincerely,

Jeffrey J. Powell
Managing Partner

The following are the sources for the widely-cited studies on illusory superiority: Svenson, O. (February 1981). "Are we all less risky and more skillful than our fellow drivers?" Acta Psychologica 47 (2): 143–148; Cross, P. (1977). "Not can but will college teachers be improved?" New Directions for Higher Education 17: 1–15; Zuckerman, Ezra W.; John T. Jost (2001). "What Makes You Think You're So Popular? Self Evaluation Maintenance and the Subjective Side of the "Friendship Paradox." Social Psychology Quarterly 64 (3): 207–223.