Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

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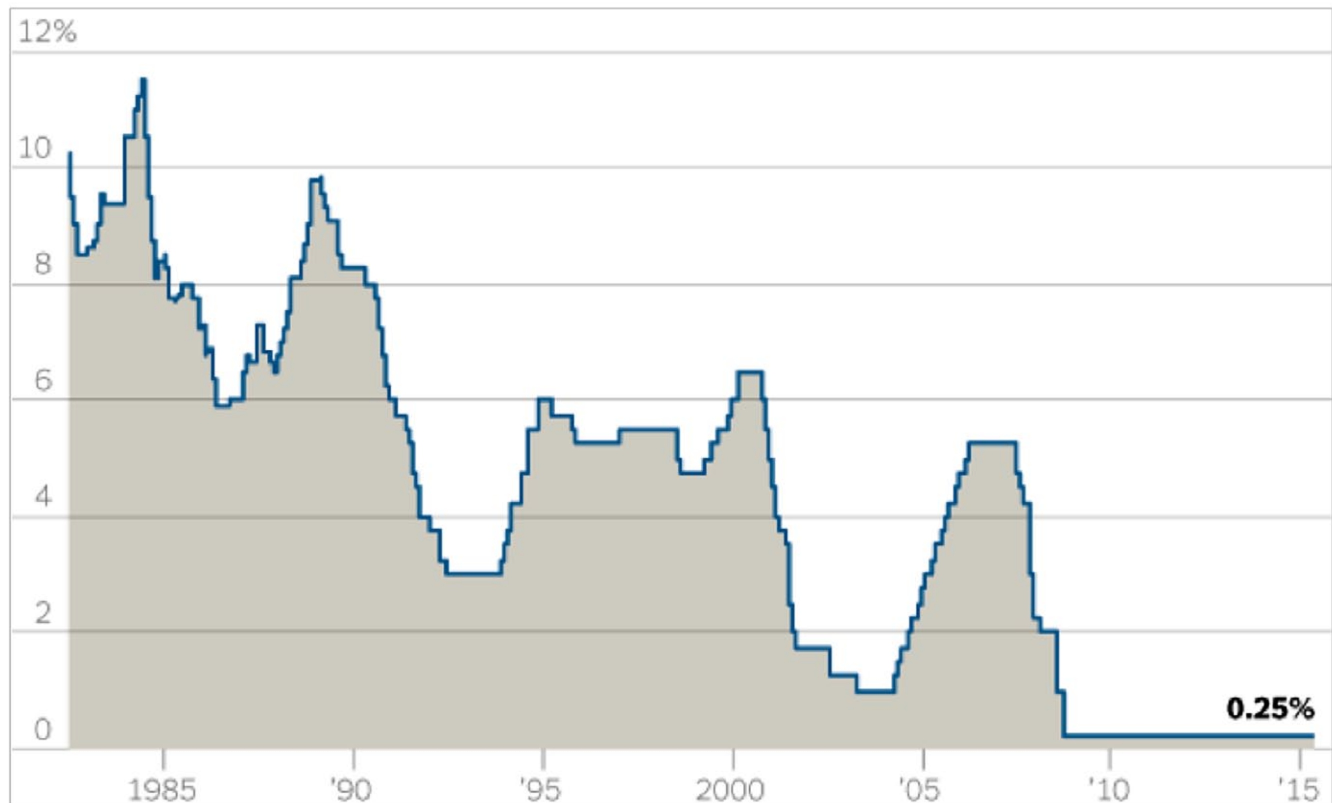
Fed Funds Rates Expected to Rise

With the December 16th Federal Open Market Committee (the FOMC) meeting rapidly approaching I felt it important to revisit the discussion of what happens to different types of investments when rates start to rise.

It seemed like pundits predicted that the Federal Reserve was going to raise interest rates as each meeting in 2015 approached. My reply has been "Even a stopped clock is right twice a day." It seems more and more likely they will get it right this time, as more economic data indicates that it is safe for the Fed to make its move. The research I've been reading places the probability between 70% and 80% that the Fed will make its first move in December.

It has been almost seven years since the Fed lowered its rates to virtually zero percent as a way to stimulate the U.S. economy (known as Zero Interest Rate Policy or ZIRP). When this didn't work the Fed turned to quantitative easing, buying bonds in the open market in an attempt to force long-term yields down. These measures eventually encouraged more lending and borrowing and normalized economic activity.



Source: Federal Reserve

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For months the Fed has been talking about a fed funds "liftoff."

The last time that the Federal Reserve raised rates was 2006. This should raise a few questions, like: Why are they raising rates? How does this impact your everyday life? What does that mean and what is the impact to you as an investor? How is Polaris Greystone investing your money based upon this information?

Why is the Fed raising rates?

Raising and lowering fed funds rates is the main lever that the Federal Reserve uses to either cool an overheated economy or stimulate a sagging one. The Federal Reserve's ZIRP was never intended to be a permanent rate. ZIRP was put into place as an emergency measure in an attempt to stimulate the economy in the midst of the Great Recession. We are no longer in an economic emergency.

The Fed is not choosing to raise rates to cool down an overheated economy. It is simply trying to bring rates back to a "normal" level after being overly accommodative. Fed funds rates were at 5.25% prior to the Great Recession. Even taking into consideration that fed funds rates have been near zero percent for almost seven years, the average rate over the past 30 years is over 3.75%.

What impact does it have on your everyday life?

It takes time for a rate hike to be fully absorbed and felt in the economy. Some things will be felt immediately while other things can take up to a year to fully take effect.

Here are some of the things that you can expect as rates go up:

- **You will get paid more for the money you have in a savings or money market account.**
- **New and variable rate mortgages will be more expensive.**
- **The cost of all other borrowing will be more expensive.**
- **The cost of real estate will most likely go down as a direct result of the cost of carrying debt becoming more expensive.**
- **The U.S. dollar will become stronger, making traveling abroad much cheaper.**

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What impact does this have on you as an investor?

Whether the Fed raises rates on December 16th or in 2016, interest rates are expected to rise over the long-term. "History doesn't repeat itself, but it does rhyme," said Mark Twain. While every market is different, there are some similarities and some "take aways" that we should identify. A rising interest rate environment doesn't have to have a material negative impact on your portfolio. You just have to understand its impact on different areas of the markets and invest accordingly.

Here are some things to expect:

- **The market's "knee jerk reaction" to the "liftoff" will most likely be short lived. In most cases the stock market will probably drop slightly on the news.**
- **Most bonds will be negatively impacted. Lower coupon and longer duration bonds will most likely see greater price devaluation.**
- **Most real estate and most REITs will be negatively impacted. It's simple economics. As rates go up the cost of borrowing goes up. Fewer and fewer buyers can absorb this additional cost creating less demand for the same supply, thus prices drop.**
- **Don't expect much from gold. There have been as many times that gold has lost value as it has gained value when interest rates were rising. See September's educational e-mail for more detail.**
- **As long as the Fed tightening is slow and deliberate the stock market's performance probably won't be materially impacted.**
  - Avoid companies that rely on leverage (aka borrowing). They will be more impacted by rising rates. Other areas to avoid include: commodity related energy (drilling, exploration and production, coal), materials, and construction & engineering stocks.
  - Companies that have large cash positions, higher interest coverage ratios, greater divided growth and lower debt-to-equity ratios should be rewarded in this environment. Some examples include: health care (managed care), consumer staples (beverages/soft drinks), and select areas of the technology sector.
  - There will be some historical deviations. One area of the market we expect to deviate from historical norms is financial stocks, especially regional banks.

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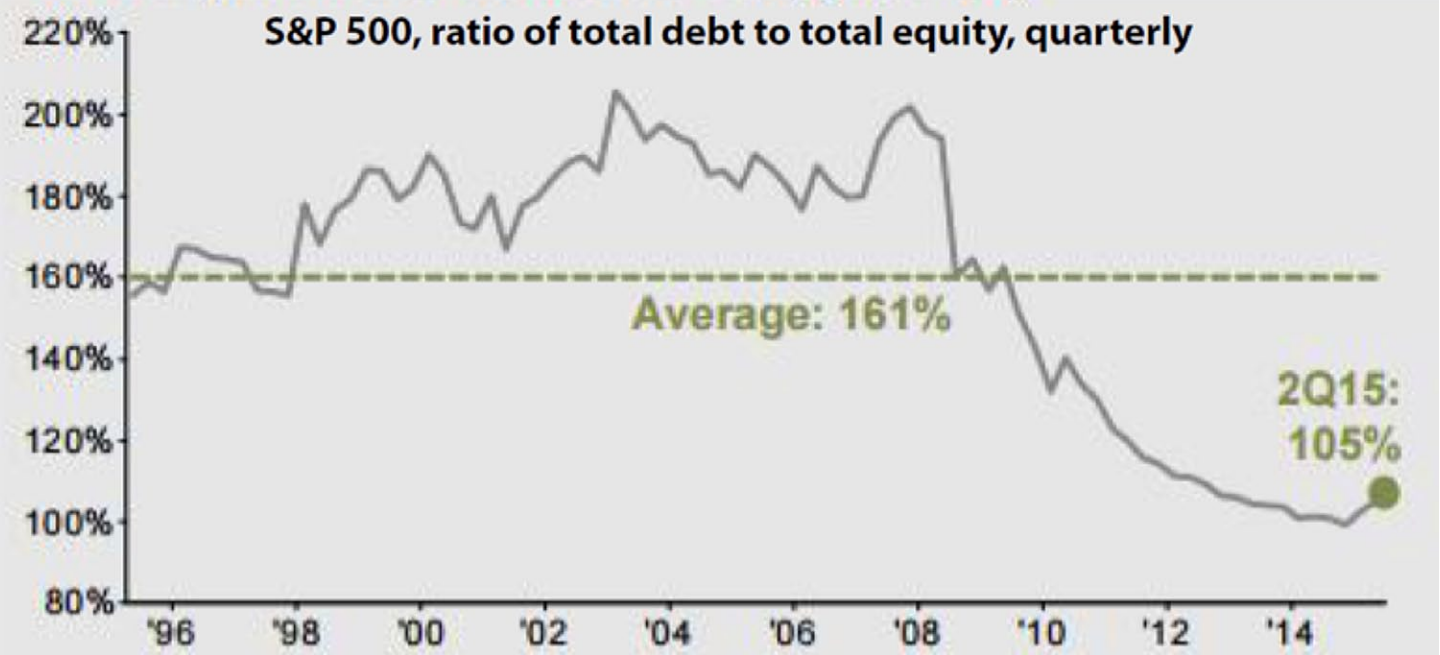
How is Polaris Greystone investing based upon the Fed raising rates?

This is a fun time to be a portfolio manager. I know that you may think I'm being sarcastic but nothing could be further from the truth. I love the challenge and know the value that we bring to our portfolio management in these types of environments.

This isn't the Alan Greenspan era when the media would predict if he was going to raise rates based upon which hand he was holding his brief case or how think it was as he walked into the Federal Reserve building. Janet Yellen has told us her plan. It's public knowledge. The Federal Reserve plans on raising rates slowly and deliberately over a several year time period. According to the notes they have published, they want to have rates above 1% by the end of 2016, in a range of 2% to 2.5% by the end of 2017, and above 3.5% by the end of 2018. This type of slow and deliberate action has not historically hurt stock market performance.

The Fed's ability to raise rates will be determined by the impact these moves have on our economy. While they are not raising rates to cool an overheated economy, we will be monitoring leading economic indicators to ensure their actions are not having unintended consequences. Any sign that the Fed's actions are jeopardizing economic growth in the U.S. would lead us to lower our exposure to the stock market.

Prior to the Great Recession the average S&P 500 company had a debt-to-equity ratio of 200%. Most of these companies deleveraged their debt. The average (as of June 30, 2015) debt-to-equity ratio is 105%. This is a huge reduction in debt and carrying cost to these companies. This means that as rates rise, these companies will be less impacted. We are investing in these types of companies.



Source: JP Morgan Asset Management. Data as of 9/30/2015

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Corporate cash for these same companies is at all-time highs.

Companies are using this cash to reward their investors in the form of record high dividends and near record high share buyback initiatives. These have very positive effects on a company's stock price. Polaris Greystone's focus is investing in these types of companies for our clients.

Cash Returned to Shareholders

Source: JP Morgan Asset Management. Data as of 9/30/2015

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As you know, Polaris Greystone is a tactical investment manager. This means that we are actively managing your portfolio in an attempt to add value where we can. We proactively manage risk by constantly evaluating the risk in the market to determine the exposure to the market we are willing to take based upon each strategy's investment parameters. As our research indicates that risk in the stock market is going up, we lower our exposure. Conversely, as risk subsides we overweight our stock exposure. We also look to identify the sectors of the market that are providing the greatest returns and try to avoid (or limit) exposure to areas of the market that are showing weakness. Then we try to identify the best investment(s) for our portfolios based upon our top-down investment process.

Your Polaris Greystone team is available to discuss your portfolio with you. Please feel free to call us to discuss your portfolio and the current market environment.

As always, I welcome your comments and questions.

Sincerely,

Jeffrey J. Powell
Managing Partner

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