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Investment Strategy Commentary

What to expect when you're expecting ... a rate hike

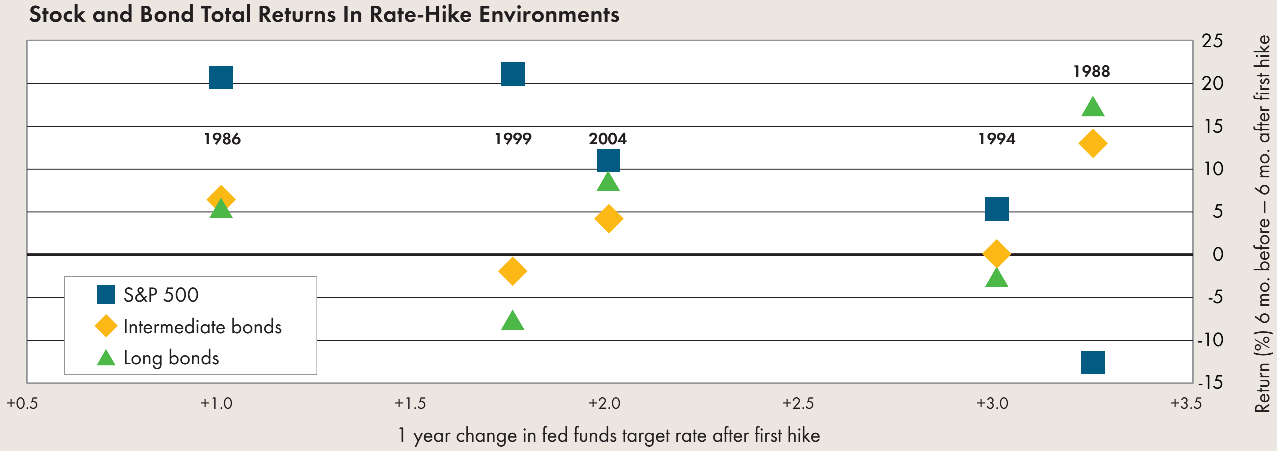
Monetary policy is currently top-of-mind, as the global monetary policy cycle is slowly transitioning from widespread accommodation toward selective normalization. What should investors expect while they are expecting the start of tighter monetary policy?

We believe the European Central Bank and the Bank of Japan will continue their easy policy over the intermediate term; however, market expectations are building around the timing of rate increases from the Bank of England and the Federal Reserve. This cycle is unlike any in the record books. Global central bank balance sheets have increased to $10 trillion in the last six years through their efforts to combat the financial crisis and the risk of deflation. The resulting ultra-low interest rate environment has led investors to take on greater credit and duration risk in pursuit of income, raising the risk of asset/liability mismatches and the resulting financial market upset should interest rates rise quickly. It is our expectation that global growth and inflation will remain moderate in comparison to historical periods, allowing the central banks to shrink their balance sheets at their own pace. The onset of a tightening cycle has historically led to a pickup in volatility, and this time should be no different—especially since the drop-off in trading by investment banks and brokers has significantly reduced market liquidity. However, if the Fed raises rates at the measured pace that we expect, financial market conditions should still be supportive of risk taking. We also think the expectations of higher rates built into fixed income markets are sufficient to allow bonds to generate positive total returns during the intermediate term.

Stocks Have Historically Handled Initial Rate Hikes Well

Exhibit 1

Stock and Bond Total Returns In Rate-Hike Environments



Sources: Northern Trust, Bloomberg, Barclays Capital. Intermediate bonds: Barclays Capital U.S. Government/Credit Index; long bonds: Barclays Capital U.S. Long Government/Credit Index.

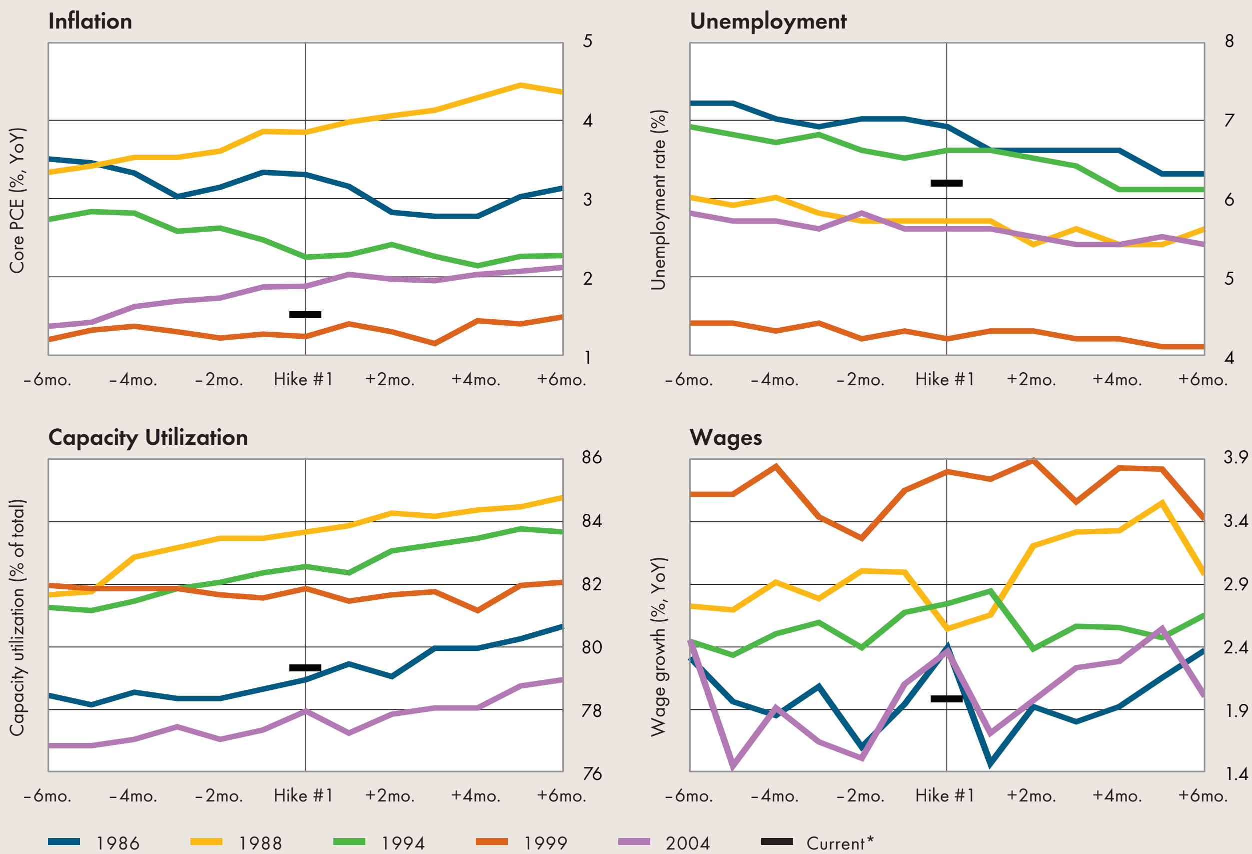
As shown in **Exhibit 1,** stocks generated positive returns in four of the five tightening cycles between 1986 and 2004 — with the exception being the 1988 cycle. The Black Monday crash of October 19, 1987, where global stocks swooned (the Dow Jones fell by 23% in a day), is included in this cycle as it occurred within six months of the first rate hike. Six months after the crash, the Fed started an aggressive rate cycle by raising the fed funds rate by 3.25% during the course of 12 months. More consistent with the other cycles, from this point forward the stock market, as measured by the S&P 500 generated a 32% return during this tightening period, as a 41% annualized earnings growth rate helped offset some contraction in price/earnings multiples.

Today, there is considerable debate about what conditions will be required before the Fed starts hiking interest rates. Indeed, the Fed itself has contributed to this uncertainty through its evolving guidance on the topic. The Fed had previously cited a 6.5% unemployment rate as one guidepost toward raising rates, but we breached that level in April 2014. The uncertainty about the state of the labor markets is such that it was the primary topic at this year's Jackson Hole Economic Policy Symposium.

In **Exhibit 2,** we show key economic indicators and their behavior in the six months before and six months after the initial fed funds target rate increases of the last five tightening cycles. The top two panels address the Fed's goals of maximum employment and stable prices. The bottom two charts display two factors that we think are also important in the Fed's evaluation of the economic cycle — capacity utilization and wages, which serve as warning signs of potential inflationary pressures.

The Data Don't Yet Call for Tightening

Exhibit 2



Sources: Northern Trust, Bloomberg. *Placement of "current" notch is unrelated to expected timing of the Fed's first hike. Historic wage growth: production and nonsupervisory workers; current wage growth: total private sector workers.

Inflation is currently well below the levels at which prior rate hikes began. We characterize several of the Fed tightening cycles as reactionary, as they began when inflation was high or accelerating (1986, 1988 and 2004). While overall inflation wasn't too high in 2004, we believe the Fed was being reactive as core personal consumption expenditures (PCE) were up 2.3% at an annual rate in the six months before the hike, and were projected to continue increasing. The 1999 cycle was proactive from an inflation standpoint, as core PCE was growing below the Fed's 2% stated goal — and the Fed was moving ahead of a forecasted jump in inflation and growth. Through these cycles, the Fed has found itself being both reactive and proactive toward inflation. We expect this Fed to favor growth stability over inflation risk, as it worries about the durability of the recovery and, therefore, tolerates the risk of higher inflation before starting to tighten policy. We also expect a benign inflation outlook to get them plenty of cover.

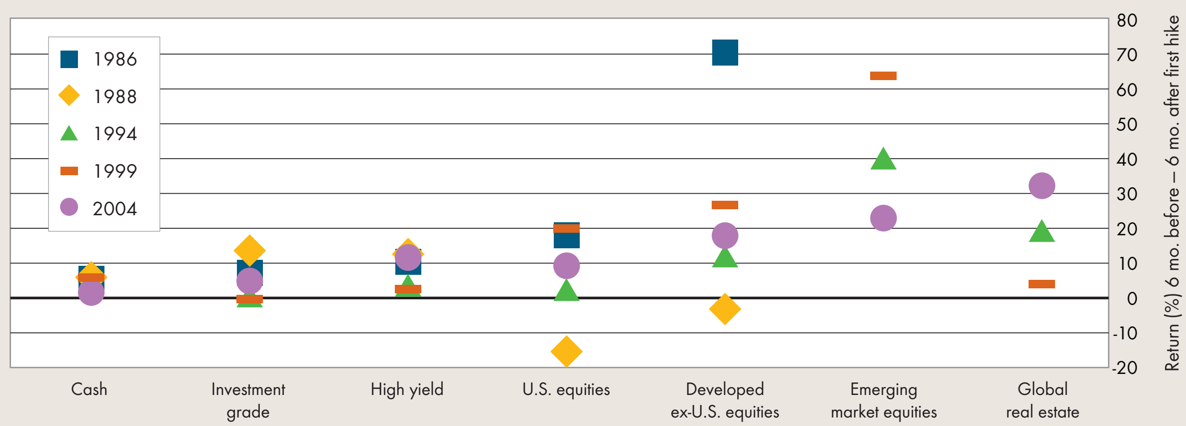
While the U.S. unemployment rate has fallen from 10% to 5.9% in the last five years, we believe this overstates the health of the labor markets. The quality of job creation has been weak, and the participation rate has fallen to 63%, a low not experienced since 1978. A broader measure of unemployment, the U-6 unemployment rate, stands at 11.8% — above the 10.7% average for the last 20 years and above the 8.9% average from 1994 through the start of the 2008 financial crisis. Reflecting this weak environment, wage gains have averaged just 2.5% in 2014 for production workers, and a meager 2.0% for all private workers (including supervisors). The current pace of wage growth, as the black notch in the wages panel of **Exhibit 2** shows, is below the level that wages were growing at the start of each of the prior five fed funds rate tightening cycles. We think sustained wage gains will be required before the Fed gets aggressive on raising interest rates. The capacity utilization figures are probably the least impactful, but they do show the current level of 79.2% approaching the 30-year median of 80.2%. Reflecting the relatively benign inflation and wage figures, the fed funds futures market first signals a hike in July 2015 and has the hike fully priced in by October 2015.

Risk assets have typically fared well in the 12 months that straddle the first hike in a period of policy tightening. Historically, the stock market has had some level of correction in the first couple of months after the first rate hike, but resumed its upward trajectory as investors aren't yet concerned that the Fed could go too far and push the economy into recession. During the course of the full tightening cycle, earnings growth is the key contributor to stock returns as valuations have tended to compress. The negative returns from 1988 stand out, but as discussed earlier, they are attributable to the October 1987 crash as opposed to the fed funds cycle. Price/earnings multiples have fallen on average by nearly 5% across all five cycles while earnings have increased at an annual rate of 19% reflecting the continued growth in the economy. Developed ex-U.S. equities, emerging market equities and global real estate have outperformed U.S. equities during prior initial rate hike cycles, reflecting the different monetary policy cycles. High-yield returns have been positive through tightening cycles as the improving economy has historically helped improve credit quality and, therefore, reduce spreads.

Most Asset Classes Have Done Well During Rate Hikes

Exhibit 3

Asset Class Total Returns In Rate-Hike Environments



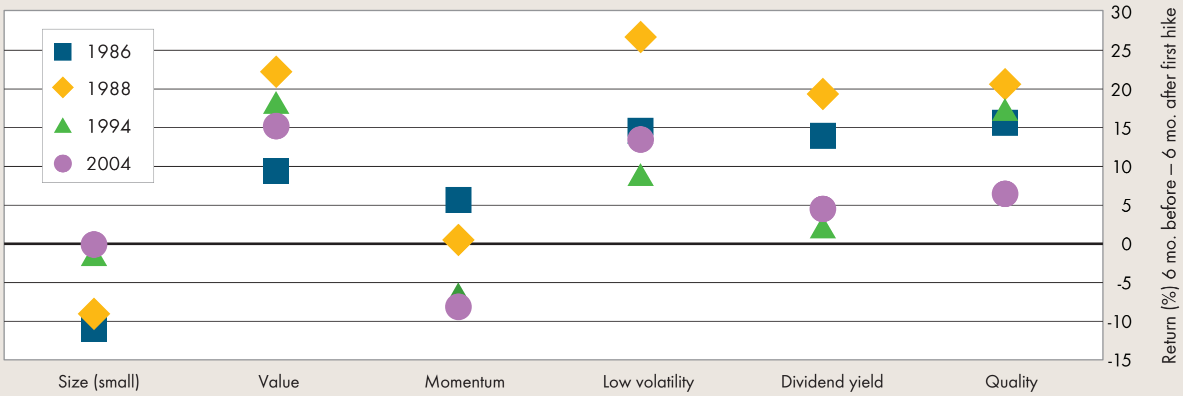
Sources: Northern Trust, Bloomberg, Barclays Capital. Emerging market equities and global real estate data unavailable for 1986 and 1988.

In addition to examining the returns of different asset classes during interest rate-hike cycles, we have analyzed the performance of different types of stocks during the cycles. We focused on the most commonly utilized equity factors (size, value, momentum, low volatility, dividend yield, and quality), which are gaining increasing traction in portfolio management. In general, the more defensive factors (low volatility, dividend yield, quality and value) have outperformed in the year surrounding the start of the Fed rate-hike cycle, while size (small) and momentum have underperformed.

A Good Defense Can Add Value

Exhibit 4

Equity Factor Total Returns In Rate-Hike Environments



Sources: Northern Trust Quantitative Research. 1999 data excluded for scaling reasons. Quality factor as defined by Northern Trust Quantitative Research.

The historical data is instructive but never fully predictive of what will happen during the next cycle. The 2004 cycle may be the closest comparison to today's environment, which suggests that a focus on defensive factors may be beneficial once the market begins to believe a hike in rates is in sight. However, we do need to take account of the current environment when considering how closely this cycle may resemble prior ones. We do expect the Fed to operate very deliberately, indicating the market is unlikely to be surprised by rate hikes. In addition, the sustained level of low rates may limit the upside to the strategy. High dividend-yielding stocks (and to a lesser extent, low-volatility stocks) are popular today as fixed-income alternatives, and have become expensive. Low-volatility stocks are less expensive as they are valued near historical averages, but they have typically been cheap prior to tightening cycles. But if the Fed does find itself behind the curve, and the markets are truly surprised by the pace of Fed tightening, then the defensive factors may outperform once again.

Conclusion

Investors will struggle with the potential impact of changing monetary policy in the years to come, as the pace of normalization is unclear and the impact of higher interest rates on the economy and financial markets is subject to debate. We have shown that historically both stock and bond markets can perform well once they have passed through an initial adjustment period. The key variable is the strength of the economy and the upside risk to inflation, as this is the scenario that could cause the Fed and other central banks to move sooner and with greater magnitude than the market expects. We think the first potential hike in the fed funds rate is still some time away, but with the Fed's bond-buying program wrapping up, we expect the rate debate to take center stage. Our current view of the economy leads us to think the Fed's eventual measured pace of rate normalization should not be disruptive to the equity markets; while our work on equity factor performance shows that defensive factors may outperform the broader market as the tightening cycle begins. N

Personal Consumption Expenditures Index (PCE) is a measure of price changes in consumer goods and services; it includes data pertaining to durables, non-durables and services.

Barclays Capital U.S. Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Barclays Capital U.S. Long Government/Credit Index is the Long component of the U.S. Government/Credit index—including debt issuance with maturities greater than 10 years.

Dow Jones Industrial Average is a price-weighted measure of 30 U.S. blue-chip companies; it covers all industries with the exception of transportation and utilities.

S&P 500® Index is an unmanaged index consisting of 500 stocks and is a widely recognized common measure of the performance of the overall U.S. stock market.

It is not possible to invest directly in an index.

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