

Investing On the Eve of Fed Rate Hikes

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US stock markets are barely positive nearly eight months into the year, and volatility is increasing. The uncertainty of potential Federal Reserve rate increases is injecting caution in the market.

The concern is valid: The Federal Reserve engineered our economy's recovery from the worst post World War II downturn by lowering interest rates to virtually 0%, and buying up over \$3 trillion in bonds. By reducing returns on riskless assets like bonds and cash, the Fed incited investors to increase exposure to riskier investments but potentially more rewarding assets like stocks; as the stock market rebounded with the renewed investor interest confidence returned, boosting the economy.

Now, amid the Fed warning of coming rate hikes, investors fear the process will work in reverse. With higher borrowing costs, businesses are less likely to expand; mortgages and car loans will become costlier, while bonds could start to look more attractive relative to stocks.

Are they right? Is the 6 year plus long bull market over?

Bottom Line

It's hard to spin Fed rate hikes as a positive. But, there are certainly lots of good reasons for long term equity investors to stay the course.

Even with several rate hikes, the interest rate environment will still be benign. A 3% ten year Treasury will not cause the nation's endowments and pensions to exit stocks in favor of fixed income.

The Federal Reserve will only hike rates when it is confident that our economy is humming. For most consumer spending, delight over a steady paycheck trumps annoying slightly higher borrowing rates.

The Federal Reserve might not hike rates at all, or quit after just one. Fed head Janet Yellen has said any hike decision is "data dependent." That means there will be no hikes in the face of poor economic news, and the Federal Reserve is as challenged to predict the economy's course as the rest of us.

Finally, a rate hike will surprise no one. Arguably, stocks already discount the hikes. Don't be surprised if stocks rise on the hike announcement, as clarity and the end of uncertainty drive a bit of a relief rally.

Corporate Earnings

Make no mistake, earnings are why you buy a stock. They provide the return on your cash layout, and permit dividends, stock buybacks, debt reduction, business expansion.

The news is quite mixed right now, as reports for the second quarter are showing the first negative year over year comparison in years. Such blue chips as **IBM, Caterpillar, United Technologies, 3M, American Express** and **Microsoft** have disappointed.

The silver lining is that much of the weakness is due to macro issues that should dissipate. Energy prices have plummeted over the last year. If you took energy stocks out of the market, earnings would be up year over year.

The other negative is the strong dollar. It depresses the value of overseas sales, plus makes exports less attractive. Example: The Canadian dollar has plunged nearly 20% in the last year. Pity the poor Vermont innkeeper trying to entice Montrealers to spend the weekend in the Green Mountains!

China weakness, as its manufacturing data drops to a 15 month low, is also weighing on results.

In any event, the most important earnings are the ones coming up, not those in the rear view mirror. We are watching carefully what the managements are saying, and stacking that up with what their stock prices are saying.

Valuations

It's not a cheap market. But, then you come back to the alternatives and you stay the course. Bonds are downright expensive.

Looking at trailing price to earnings ratios, the market's at its most dear since the late 1990s. Price to earnings ratios are nearly 21 on trailing earnings, versus 16 historically, but 31 in 1999. Using Robert Schiller's metric, average earnings over the last decade, you reach a similar conclusion, as it's at 25.8 versus 24.7 historically.

Warren Buffett likes to compare the value of all stocks relative to our GDP. That measure, too, points to over valuation by 80%! On the other hand, given how much international business our multinationals do, to compare global stocks with a domestic GDP seems mistaken. Therefore, his metric is not dispositive.

Markets can stay expensive for a long time. Alternatives are very expensive. Stock prices may look less expensive as earnings rise. Valuations alone do not justify jumping ship.

The US Dollar

The US dollar has risen a remarkable 25% in the last year versus a basket of currencies. An expensive dollar dampens our economy, holding down inflation. Some see it as directly equivalent to a rate hike.

Foreign countries are directly targeting the dollar. By devaluing their own currency, they gain a trading advantage.

The best known currency comparison is the US dollar versus the Euro. Currently at less than 1.1 dollars to the currency, the all-time low rate is a Euro worth just 82 cents.

A sharp move up by the dollar will crimp economic activity. If it were to get to 82 cents, undoubtedly the Federal Reserve would put all rate hikes on hold. So, worry less about a rate hike as the dollar strengthens, but watch out for weaker earnings.

The Economy

First quarter weakness was chalked up to severe winter weather, and has given way to modestly improving conditions. The residential real estate market is quite busy, and is starting to approach its 2007 peak, but not on an inflation adjusted basis. Autos continue strong, too, at a near 17 million a year pace, best since 2005.

The all-important labor market is the Fed's key metric; vastly improved jobs numbers are finally giving way to some increase in compensation. Troubling still is a disturbingly low participation rate, worst since the '70s, suggesting jobs are not so plentiful as to entice many off the couch.

Manufacturing has been volatile, impacted by the strong dollar. Low gas prices are giving a tail wind to consumer spending, and are expected to remain so. Recent economic data is mixed.

Although the Federal Reserve's mandate is employment and inflation in our economy, there's no question it's looking over its shoulder at the global economy. There, the view is not pretty, as nearly all central banks are taking the opposite tack to our Federal Reserve by increasing liquidity and tolerating currency weakness to ward off recession in their economies. Bottom line, continued weakness overseas could increase Fed reticence to do much rate rising.

Bad Boys China and Greece

Markets have been buffeted recently by both China and Greece.

Greece is of lesser concern, but certainly bears watching. Burdened with too much debt, and straining under austerity measures, for right now a deal has been reached to keep them within the Eurozone and to extend further funding in exchange for even greater austerity measures.

Few see how Greece can ultimately pay back its debt; Germany in particular is adamantly opposed to writing it down. The good news is that the debt ownership has shifted to the public sector thus posing less systemic risk to the banking system.

China, as the globe's second largest economy, represents greater risk. It's hard to square a putative GDP growth rate of 7% with the need for the government to prop up the stock market. Q2 results from companies doing business in China have been a mixed bag, with some citing unexpected weakness, while others concerned but so far not seeing the fallout.

China is going to be a huge headache for the Fed; hiking rates in the face of material weakness there is not something it wants to do. Stay tuned.

Investment Strategy

We prefer sectors that have been pummeled this year due to fears on rising rates. Why? The pain if Fed rate hikes prove more aggressive than expected will be less than the relief rally if the Fed proves more dovish.

Consider high quality energy companies like **Exxon (XOM)**. The sector is down nearly 30% over the last year, so much of the pain is already discounted. This company now boasts a dividend yield of 3.4%.

Utilities have also been pummeled; dividend seekers have dumped dividend stocks out of fear of rising rates. Utilities have dropped nearly 10% this year as a result. One of the biggest and most diversified is **Exelon (EXC)**, with a dividend yield of 3.8%

Chemical companies have also been out of favor, partly out of concerns over global growth and the strong dollar. We favor **Dupont (DD)**, an undermanaged company that fended off Nelson Peltz (this time) but which needs to streamline and better highlight faster growing areas within the company. Current dividend yield is 3.2%

What to Avoid

Junk, or high yield bonds, would be at the top of the list. Investors have piled into these investments, craving the income that's no longer present in the fixed income market, but oblivious to the risks.

The risks come in several flavors. First, is interest rate risk. If rates rise, whether due to Fed hikes or simply due to bonds being dumped, all bonds, even high yield bonds, will be under pressure: Investors will gravitate to the new higher yielding versions.

The second is credit risk. While the economy seems on the right foot now, higher rates and weakness overseas could spell problems. Not as well known, too, is that the biggest sector representation in the high yield market, at 14%, is the energy patch. Paying back your debt doesn't get easier with energy prices down over 50%.

Finally, exchange traded funds (ETFs) have allowed millions to believe they have easy junk bond liquidity despite the illiquid nature of this asset class. High yield ETFs have not been tested by a bear market with investors cashing out fast. At some point, high yield ETFs may have to try to exit their holdings as quickly as possible, and that may not be very fast due to the relatively small capitalization and thin trading of many junk bonds. Pricing could get volatile.

In sum, remain wary of upcoming Fed rate hikes. But, given the overall low interest rate environment your best move may be to look for solid franchise stocks in underperforming sectors. Don't just stuff your money in the mattress.