Looking Forward While the Fed Is Looking Up

The year is rapidly coming to a close, and next week the Fed will meet for the last time in 2015. The world is anxiously waiting to see whether the Fed will raise interest rates, and what it will mean for markets. We believe economic data is strong enough for the Fed to begin raising rates, and that the United States will move on a slow path toward interest rate normalization.

What we expect from the December Federal Open Market Committee meeting

The recovery in the United States labor market since the financial crisis has been quite slow, but after more than six years of adjustments, genuine improvement is now evident, notably in employment and wage data. The labor market is still not firing on all cylinders, but it is undeniable that the engine is more robust than it was just a year ago. Consumer price inflation continues to undershoot the Fed’s 2% target, but we are seeing upward pressure on wages in many sectors, which suggests an upward bias to the inflation outlook in 2016. The slow expected path of rising inflation in 2016 is the primary reason why we expect the Fed’s rate hike cycle to be very gradual. Our expectation is that at the December meeting we will see the Fed take the first step toward higher interest rates by increasing the federal funds rate by 25 basis points. Looking out to year-end 2016, federal funds futures are pricing in a rate of 0.75% to 1.00%, but our view is that the Fed’s pace will be slightly faster.

Investing in a rising interest rate environment

The path toward interest rate normalization will have unique implications for various asset classes and sectors. Below is a summary of our views of these outcomes, which should be discussed with your J.P. Morgan representative, particularly for clients who hold self-directed accounts.

Equities

While we do expect volatility as a result of the Fed moving off of a zero interest rate policy, we believe it is ultimately a positive sign. The U.S. economy is strong enough not to require exceptionally low policy interest rates to sustain itself. We believe U.S. equities (as measured by the S&P 500) will be supported by earnings growth of 5%–6% next year. However, returns by sector will vary significantly. Specifically, we would recommend reducing broad exposure to utilities and telecommunication companies for those who have existing positions. These sectors could have an adverse reaction to higher interest rates, as they are often used as bond proxies in low interest rate environments. We would add exposure to financials and consumer discretionary.

We believe the U.S. financials sector should benefit as a result of the positive impact of rising rates on banks’ net interest margins: the spread that they earn between interest rates paid on deposits and those earned on loans. We prefer U.S. domestic banks (both large cap and regionals) that are levered to a growing U.S. economy and benefit from the ongoing housing recovery, demand for new loans, and lower delinquency rates on existing loans.

The Fed’s decision to increase interest rates is partially a reflection of the health of the U.S. consumer: Gas prices have declined (effectively a boost to disposable income), job gains have averaged 200,000 per month, wages are increasing, and there is increased access to capital (i.e., debt). We expect all of these tailwinds to drive a broader recovery in consumer spending and more participation from all segments of households, and ultimately a strong opportunity for the consumer discretionary sector. Investors should consider accessing the sector selectively, in areas within consumer discretionary such as e-commerce, home improvement, and companies with specialized products and services (e.g., athletics, entertainment, intellectual property).

Outside of the United States, we are constructive on European and Japanese equity markets, as central bank policy in those regions remains accommodative, with low interest rates supporting further economic growth. In Japan, we are focused on the banking sector, which should benefit most from structural reform and a greater emphasis on shareholder returns. Within Europe, we believe domestically focused cyclicals and real estate equities are best positioned, given their leverage to an improving Eurozone economy and limited exposure to emerging market headwinds.
Fixed Income

Fed normalization cycles have traditionally given fixed income investors reason for caution. However, not every cycle is the same, and we believe this cycle will indeed be more moderate in pace than what has historically been the case. Our expectation of a slower pace of rate increases and modest inflation results in a view that longer-term (10-year) U.S. Treasury yields will remain in a fairly tight range. As a result, we remain positive on preferred equity opportunities in the financial sector as well as certain high yield issuers outside of the mining and energy sectors. We suggest that very short-term fixed income should be, in part, diversified into absolute return managers and longer-term municipal bonds for those seeking tax-efficient income.

Where appropriate, we recommend building a diversified allocation of qualified dividend income (“QDI”) eligible bank-preferred equity. Selectivity will be critical, and we suggest avoiding specific preferred structures with lower dividend rates, which we expect to underperform in a rising rate environment. Within the corporate high yield market, we prefer the non-energy portion of the market, with a specific bias to add exposure on any short-term weakness.

Portfolios that are concentrated in very short maturities should consider swapping some of that exposure in favor of more absolute-return-oriented managers who we believe are adept at navigating volatile fixed income markets. For those in high tax brackets, municipal bonds may be higher yielding versus many other fixed income alternatives. Clients who have higher cash allocations than desired may find that higher-quality municipal bonds offer an attractive way of putting that cash to work. Income-focused investors should consider selling some shorter-dated municipal bonds and swap exposure into maturities in the 10-to-20-year range.

Currencies & Commodities

For the past two years, the expectation that short-term rates in the United States would begin to rise, combined with continued easy monetary policy from other developed market central banks, has considerably benefited the U.S. dollar. Given our view that the Fed will raise interest rates slightly faster than market expectations, as indicated by federal funds futures, we believe there is additional room for the U.S. dollar to appreciate near term. However, that appreciation will be fairly tempered, and we recommend that those with longer-standing short Euro/long U.S. dollar positions begin to realize gains. Clients who hold short Euro positions to hedge longer-term assets, including equities, may consider keeping those hedges in place.

We anticipate U.S. dollar strength will be pronounced against those economies with more fragile growth outlooks and potential further easing ahead. Australia, for example, stands out for consideration, given the potential that interest rate cuts by the Reserve Bank of Australia will erode its status as a “high yielding” currency from a developed economy.

U.S. dollar strength is also likely to weigh on U.S. dollar-priced commodities, particularly in sectors dealing with excess supply. We continue to recommend reducing exposure to oil, copper and iron ore, as appropriate. The central argument for this view is that producers of these commodities have broadly responded to lower prices by focusing on cost reduction rather than curtailing supply.

Borrowing in a rising interest rate environment

Historically low interest rates have allowed many clients to access low-cost capital for a variety of purposes. Higher interest rates will likely result in a gradual increase in borrowing costs for those with floating-rate loans. In anticipation of rising short-term interest rates in the United States, we suggest that you evaluate your borrowing strategies to help ensure your liabilities are appropriately structured in the context of your overall portfolio. Considering your liquidity needs, financial goals and view on interest rates will help to determine whether you should remain floating, lock in a fixed interest rate, or a combination of the two. For those who have not considered borrowing, we believe that now is an opportune time to access low-cost financing at a fixed rate using a fixed-rate loan or mortgage.
In Summary

We believe the underlying momentum in the U.S. economy warrants a change from the zero interest rate policy of the past seven years. We expect a slow but steady rise toward higher policy rates. In order to help ensure that your entire portfolio is positioned for this change and the related views outlined above, we encourage you to have a conversation with your J.P. Morgan representative. Together, we can review your objectives and consider any necessary reallocations to your portfolio.

See next page for disclosures.

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