CAPITAL ADVISORS

Market Comment
September 14, 2015

What Monetary Policy Means for You

Anyone interested in the topic of monetary policy will have ample opportunity to read up on it this week because the financial media might hyperventilate over its coverage of the Fed's policy meetings on Wednesday and Thursday. We have little to add to this subject that won't be covered elsewhere, so we won't elaborate here. The purpose of this piece is to offer our best guess as to how an increase in the Fed-funds rate might influence Capital Advisors' portfolio strategies. For context, prices in the futures market suggest there is only about a 25% chance of a Fed rate hike this week (source: *CME Group*), so this exercise may be premature.

Fixed Income Strategies: The most direct channel of influence for monetary policy is the bond market. *Usually*, higher interest rates at the short end of the yield curve (i.e. bonds maturing within 1-3 years) translate into rising yields further out on the curve (i.e. bonds maturing in 5-20 years). Since bond prices move inversely with interest rates, conventional wisdom suggests that investors should limit their exposure to longer-term bonds whenever the Fed embarks on a tightening cycle of periodic rate increases.

We emphasize the word "usually" because bonds have behaved differently since the financial crisis. Although the Fed has not tinkered with the Fed-funds rate since 2008, they have tightened monetary policy three times through other means. This occurred when the Fed terminated each of three quantitative easing (QE) programs. In each case, long-term interest rates were expected to drift higher once the Fed stopped buying billions worth of bonds associated with these programs. Instead, long-term rates went *down* after all three QE programs were terminated.

We shifted a portion of our fixed income model portfolios further out on the yield curve earlier this year to reflect this dynamic in the bond market. This strategy has worked well so far by allowing these portfolios to earn a higher yield throughout the year while the Fed held off from raising rates up to, and potentially beyond the upcoming policy meeting.

Even though we moved out on the yield curve, our fixed income portfolios should be resilient to rising interest rates because we only extended maturities to the 5-7-year range, while maintaining ample exposure to the shorter end of the yield curve. We believe our fixed income portfolios are well positioned for a gradual pace of monetary tightening, and it makes little difference whether the first rate hike occurs this week, or several months down the road.

Tactical Strategies: In addition to the bond market, monetary policy can have a material impact on the global currency markets. Since investors can borrow money in one country and reinvest in another, countries with relatively higher interest rates tend to attract capital, causing their currency to appreciate. If the Fed raises short-term rate it is widely expected to extend the recent strength of the dollar, particularly relative to many emerging market currencies. This has the potential to be problematic because corporations throughout the emerging world have issued hundreds of billions worth of dollar-denominated debt in recent years. When the dollar strengthens, this debt becomes harder to repay.

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If emerging market stocks suffer collateral damage from a shift in domestic monetary policy our tactical strategies seem well positioned to avoid material harm. The *Dynamic Allocation Strategy* sold out of emerging markets completely in July, while the allocation to emerging markets in the *Tactical Global Growth* and *Tactical Global Income* strategies is at the minimum point of the range for both strategies.

A rising dollar can also put downward pressure on natural resource industries because many commodities are priced in dollars for global trade. Here again, our tactical strategies seem appropriately positioned for such an outcome. The *Dynamic Allocation Strategy* sold out of the natural resource sector in June, while the allocation to natural resources in *Tactical Global Growth* and *Tactical Global Income* is at the minimum point of the range for both strategies.

All things considered, our tactical strategies may be better positioned for the first rate hike to come sooner rather than later, particularly if a rate hike sustains the recent under-performance of emerging market equities and natural resource industries.

Managed Equity Strategies: We don't expect either of our managed equity strategies to suffer lasting harm if the Fed raises rates on Thursday. We would normally expect the *Managed Equity Dividend* strategy to be vulnerable to a rate hike, at least in the short-term. However, traditional interest-sensitive sectors like utilities, real estate, and midstream energy have already dropped a lot in recent weeks, leading us to wonder if higher interest rates are already priced into many of these stocks. We would not be shocked if a rate hike on Thursday ultimately *helps* these sectors to find support in the stock market; not necessarily in the immediate aftermath of the announcement, but soon thereafter perhaps.

In Summary, the timing of the Fed's first rate hike is far less important than the pace and magnitude of subsequent monetary tightening. All indications from the Fed up to now suggest they will be *very* patient with subsequent rate increases once the first move is on the board. On balance, we believe Capital Advisors' portfolio strategies are positioned better for the first rate hike to come sooner rather than later. However, should the Fed kick the can down the road again on Thursday, our strategies should do fine with that as well.

Because the divergence of opinion about what the Fed will do is much wider than usual, market volatility may be higher than average this week since one side or the other will be forced to re-position after the Fed's decision. Elevated volatility should not be cause for alarm.

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