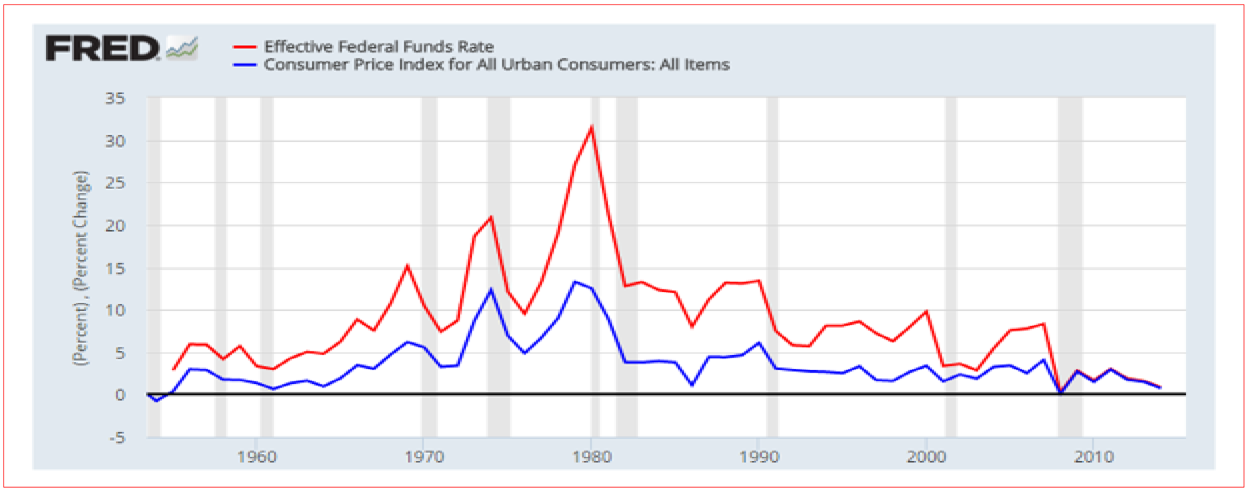
FED RATE HIKE

Federal Reserve Chair Janet Yellen appears to be set on raising interest rates. Friday's nonfarm payroll report of 211,000 new hires certainly supports her quote below.

> *"I currently judge that U.S. economic growth is likely to be sufficient over the next year or two to result in further improvement in the labor market. Ongoing gains in the labor market, coupled with my judgment that longer-term inflation expectations remain reasonably well anchored, serve to bolster my confidence in a return of inflation to 2% as the disinflationary effects of declines in energy and import prices wane."*

The FED is nearing liftoff of its first rate hike since June 2006, back when the Fed Funds rate stood at 5.25%. It has hovered around 0.25% since the FED's last rate cut on December 17, 2008. Historically, the Fed Funds average rate has been near 5%. It reached as high as 18.9% in January 1980 and fell as low as 0.07% in January 2011. So, how will this affect market behaviors and investment outcomes in the months to come? To answer the question, an historical look back is in order.

When the FED raises rates it is known as the "tightening cycle." During this period, the FED is focused on keeping the economy moving along but with less intensity. Raising rates, i.e. tightening, is said to help the economy from growing too fast. Ideally, higher interest rates put a lid on aggressive borrowing and curtail asset appreciation. By moderating economic growth, the FED is able to achieve its dual mandate of price stability and full employment. A growing economy and tame inflation can be the best of all worlds for its citizens. It allows them to have steady work/income and the ability to purchase goods and services at affordable prices.



Since World War II, the tightening phase has been less desirable for investors than it has for consumers. According to the Maven of Manhattan, Sam Stovall, there have been 16 rate hike episodes; in aggregate, 6 months before and 6 months after the initial rate hike, the S&P 500 has experienced meaningful sell-offs that have averaged **-16.3%** and **-15.2%** respectively. It has been said that history does not repeat itself but it often rhymes - "Fight the Fed and soon you'll be dead." Prudent investors are sure to gird themselves during this timeframe.

If the past is prologue, and there is no guarantee that it is, there just may be a bit of a silver lining to this story. Since 1946, the S&P 500 on average has rallied from its low point during the 6 months after the hike to post a average 1.3% net price return. 1.3% may sound like a modest sum, but is it? If the market follows historical norms, and corrects by 15.2%, then subsequently rallies to plus 1.3% by the end of June, that's not so bad. The reason for the tightening in the first place is because the economy is showing strength.