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Asset Management, Inc.

Turn Up the Music

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Reflections & Perceptions

Returns were hard to come by in the large cap space again during the second quarter 2015. The S&P 500 Index was up just 0.28% over the last three months, despite hitting all-time highs in mid-May that were more than 3% higher than the June 30 close. The latest sell-off was attributed primarily to the newest chapter in the ongoing Greek saga – an impending debt payment and the potential for a Greek default. Given the small size of the Greek economy, the market reaction to a potential default signaled bigger issues, like the uncertainty over the path for the Euro, concerns over sluggish year-over-year earnings growth domestically, the timing and extent of Federal Reserve interest rate normalization and valuations. And now, as we close the second quarter, additional concerns surface as stocks listed on mainland China's most prominent exchange tumbled 30% from their seven-year highs in just a short three weeks.

While it may seem that there is much to be concerned about, we will attempt to keep our focus on issues that are most important to our markets. On a year-over-year basis, S&P 500 earnings are expected to be down slightly in the first six months of 2015 compared to 2014, with growth resuming in the second half of 2015 and into 2016. As we discussed last quarter, depressed earnings in the Energy sector due to the steep drop in oil prices since mid-2014 account for much of the S&P 500's lowered 2015 growth expectations. Contributing as well to the downward revision in earnings has been the negative translation effect of a sharply strengthening dollar since the beginning of the year.

With a flat quarter and little movement in consensus estimates, aggregate valuations have stayed steady over the last three months. The S&P 500 was selling for 17.6x the current year's earnings estimate of $117.25 as of 6/30/15, compared to roughly 13x – 14 xs in the 2010-2012 time frames. The current valuation is slightly above this measure's 20-year average of 16.7x, but well below the high for the period of 29.2x set in early 2000. As a result, we expect stock prices to trend higher as long as the expectation for earnings growth remains intact.

It has been nearly nine years since the Federal Reserve last hiked rates which was in July of 2006 at the end of the last tightening cycle. Since the 2008 financial crises, the Federal Reserve has held short-term interest rates at essentially zero to support the economy. With steady employment gains, a declining unemployment rate and an improving economy, the Federal Reserve has been signaling its intent to begin raising rates, perhaps as early as September 2015.

We thought it would be instructive to review how domestic equities have performed since the Federal Reserve embarked on its extraordinary rate policy back in 2008. As the table below shows, the Fed's aggressive policy has rewarded investors for taking on risk. Due to the length and degree of appreciation of the current bull market, it's only natural that the markets are concerned about the prospects of Fed interest rate hikes and their impact on equity markets.

	Annual Returns					
Index	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
S&P 500 Index	26.46%	15.06%	2.11%	16.00%	32.39%	13.69%
Russell Mid Cap Index	40.48%	25.47%	-1.55%	17.28%	34.76%	13.22%
Russell 2000 Index	27.17%	26.85%	-4.18%	16.35%	38.82%	4.89%

Source: Standard and Poor's, Russell Investments

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While each tightening cycle has been driven by different factors, past cycle history may provide guidance on what to expect when rates eventually do head higher. Over the last 30 years, there have been five tightening cycles. One common factor in the months leading up to each of the Fed's initial rate hikes was an improving macroeconomic environment. Labor market data has had a strong influence on fed policy as each cycle experienced a steadily declining unemployment rate and strong employment payroll data, as is the case today.

Interest rate increases have historically led to greater equity market volatility, but they have not always signaled the end of a bull market as the table below indicates. While the 1999 and 2004 tightening cycles did end with major stock market crashes, we believe this had more to do with exogenous factors, such as the dotcom crash of 2000 and the financial crises of 2008. The table below shows that in four of the last five cycles, stocks generated positive returns twelve months after the Fed first increased the federal funds rate with the 1994 tightening cycle being the exception.

Fed Rate Hike Cycle	Fed Funds Rate Beginning	Fed Funds Rate End	Fed Funds Rate Change	S&P 500 Return
06/2004 - 06/2006	1.00%	5.25%	4.25%	7.81%
06/1999 - 05/2000	4.75%	6.50%	1.75%	9.65%
02/1994 - 02/1995	3.00%	6.00%	3.00%	0.67%
03/1988 - 02/1989	6.50%	9.75%	3.25%	15.09%
12/1986 - 09/1987	5.88%	7.25%	1.37%	35.35%

Source: Lord Abbett, Federal Reserve Bank of New York, Standard and Poor's

If history is any guide, domestic equity indices stand a good chance of producing positive total returns during the next tightening cycle. That being said, there are numerous reasons why the next rate hike cycle could impact equities differently than history suggests. Most significantly, the Fed's unprecedented policy response to the Great Recession of 2008 may have created special challenges that markets have not foreseen. In addition, we may be underestimating the impact on financial markets of a Greece exit from the Euro zone and/or the impact of the sharp decline in Chinese markets on global economic activity.

In conclusion, in her post June Fed meeting news conference, Federal Reserve Chairwoman Janet Yellen suggested that the path of the next rate cycle would be both broad and shallow. In addition, she stated that there should not be too much importance given to the first rate hike. These outwardly dovish statements suggest that the pace of this cycle should leave rates at a still accommodative level. Interestingly, the Fed has historically raised rates to reign in excessive economic growth and contain or lower inflation. It seems that the Fed's current objective is in stark contrast to historical norms. Instead, it appears that the Fed is focused on normalizing interest rates without adversely affecting economic growth. Arguably, this more dovish stance could favor equities more than past rate hike policies, when economic slowdown was part of the Fed's policy goal. Therefore, if the Fed is successful in its implementation of rate hikes, interest rates can move gradually higher without seriously affecting the economic growth that supports corporate earnings, and in turn, equity valuations.

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