Positioning Portfolios for a Potential Rate Hike

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In two weeks, the Federal Reserve will decide whether to raise the federal funds interest rate. If it happens, it will only be the second increase since 2008, and they will be doing it knowing that the first increase late last year was followed by a period of market calamity. We think the probability of a .25% rate hike in either June or July is greater than the market currently expects – the Fed Funds futures market currently expects about a 50% chance of a rate hike before September. However, we think any hike will be accompanied by guidance that future rate hikes are unlikely without substantially more growth in the global economy (known in "fed speak" as "dovish language"). In the table on page 2, we show the asset classes that we believe would benefit from, and get hurt by, such a move.

In previous more robust recoveries, fed funds rate increases tend to "work" for the economy and markets (i.e. maintain positive momentum) when they are implemented to combat an economy that the Fed perceives is growing too fast and potentially generating inflation. In that scenario, while the interest rate increase is designed to slow down the economy, the implicit message it sends is that the economy is healthy or even too strong and needs to be cooled off a bit. In our view, we are not currently experiencing this type of robust recovery.

If the Fed decides not to raise rates over the summer, we think the negative signal it would send to markets – that the US economy is too weak to sustain higher interest rates – could have a greater impact than the rate increase itself.

With inflation expectations currently well below 2% in the US and below 1% in Europe and Japan, we believe it is difficult to argue that the rate increase is necessary to temper inflation. However, financial markets fluctuate based on the confidence of future earnings as much as current fundamentals. If the Fed decides not to raise rates over the summer, we think the negative signal it would send to markets – that the US economy is too weak to sustain higher interest rates – could have a greater impact than the rate increase itself.

The Federal Reserve is therefore in a delicate position, as the domestic economy has now been growing slowly but steadily for six years and there is much less slack in the labor market. However, in our opinion, there is no course of action that does not adversely affect at least one important constituency: emerging markets. Because many emerging market economies denominate their debt in US dollars, they are extremely sensitive to interest rate increases, since a rate increase not only raises the cost of new debt, but probably weakens their exchange rates, thus increasing the cost of repaying dollar-denominated debt. Further complicating the issue, China is opposed to a strong dollar, because it creates a strain on their central bank and reserve system due to their quasi-currency peg to the dollar. The Europeans and Japanese, meanwhile, would happily accept a stronger dollar to help their earnings from overseas. In the US, higher rates threaten the recovering housing market, the credit markets, and multinational corporate earnings, but would greatly help banks, pension plans, and yield-starved savers and retirees.

Handicapping the four possible outcomes of the June/July meeting:

1. .25% rate increase and dovish language – most likely, in our view
2. No raise and dovish language – less likely
3. .25% rate increase and hawkish language – unlikely
4. No raise and hawkish language – most unlikely

RIVERFRONT'S ASSESSMENT OF POTENTIAL IMPACTS OF SCENARIO 1, ABOVE

The following chart provides a guide to the potential winners and losers from scenario number 1 above, which we believe is the most likely outcome.

Asset Class	Reaction if Fed raises rates by 25bps	Reaction if Fed gives dovish guidance	Assessment of Potential Impact
Treasuries	↓↓	↑	Negative
High Yield Credit	↓	↑	Slightly positive
US Equities	↓	↑	Slightly Positive
US Dollar	↑↑	↓	Slightly Positive
US Banks	↑	↓↓	Neutral
US Housing	↓↓	↑	Neutral
Energy / MLPs	↓	↑	Slightly Positive
Europe / Japan	↑	↑↑	Positive
Emerging Markets	↓	↑↑	Neutral

Source: RiverFront Investment Group. The chart above is provided for illustrative purposes only and not intended as an investment recommendation. Please see below for important disclosure information related to the asset classes discussed above. The above is RiverFront's opinion current as of the date of this publication.

As you can see from the chart, if our predictions are correct, there are a lot of offsetting signals in the two separate Fed actions. Our views expressed in the 3rd column are subjective and based on our knowledge of how these asset classes are valued and how they typically respond to Fed policy. Beyond these shorter term predictions, we feel compelled to remind investors that:

1. Valuations are far more important to your long-term returns than any single event. While monetary and fiscal actions can act as catalysts to push assets towards their fair valuation, we believe the best way to meet your financial goals is to focus your investing on areas that are long-term performers. We believe our long-term valuation work aligns with the asset classes that stand to benefit from this potential rate increase, meaning that this Fed announcement has the potential to be a helpful catalyst for our positioning.
2. If our assessment of the Fed's actions is not correct, we believe that currently depressed valuations should provide a "margin of safety" for many of the assets we like. We are also encouraged that other central banks continue to have policies that we believe align well with our positioning.

Important Disclosure Information

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities. In a rising interest rate environment, the value of fixed-income securities generally declines.

Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

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RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Diversification does not ensure a profit or protect against a loss.

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It is not possible to invest directly in an index.

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