Morrows Knows

Investment implications of rising US interest rates

What will the end of US Quantitative Easing and rising interest rates bring for markets? A topic of hot contention, how markets will react when the US Federal Reserve (Fed) ends its Quantitative Easing (QE) program and raises interest rates remains a key investment consideration. We believe that these two factors will keep markets on edge over coming months and we discuss this in more detail below.

This month the US Federal Reserve (Fed) met and trimmed another $10 billion from their monthly asset purchase schedule, taking it down to $15 billion per month, which is expected to completely disappear in their October meeting.

On this basis, while there are many ways to describe the equity market since 2008, it is hard to deny that for the last six years we have been in a **Quantitative Easing market**. The chart below shows how the markets have reacted as each of the US QE programs came to an end and then how they immediately rebounded as the next QE program took off.

For instance, after the Fed announced a 'tapering' of its QE3 asset purchases in late 2013, markets reacted negatively but this was short lived. Since then, the US equity market has continued to push through record highs supported by low interest rates and accommodative central bank policies.

It remains to be seen how markets will react when the Fed completely removes its QE3 stimulus in October, but what is even more uncertain is how markets will react when the Fed announces that it will start to raise interest rates.

The expectation is that interest rate increases will be modest and measured. However, we have never been in an environment where interest rates have remained so low for so long, and Morrows expects this to have unintended consequences.

It could be argued that markets have risen on the back of QE stimulus programs and low interest rates, and therefore it could be argued that markets may fall as QE unwinds and interest rates rise. Whatever the outcome, we can expect volatility to rise going forward.

This is now one of the longest equity bull market rallies that we have seen without experiencing a significant correction along the way. Over recent years markets have largely shrugged off any challenges put in front of them, however, we may now be heading into the biggest challenge we have faced for some time – **rising US interest rates**.

The chart below from *Epoch Investment Partners* shows that the US economic recovery from 2007 to today has been sub-par relative to the recoveries of past recessionary periods.

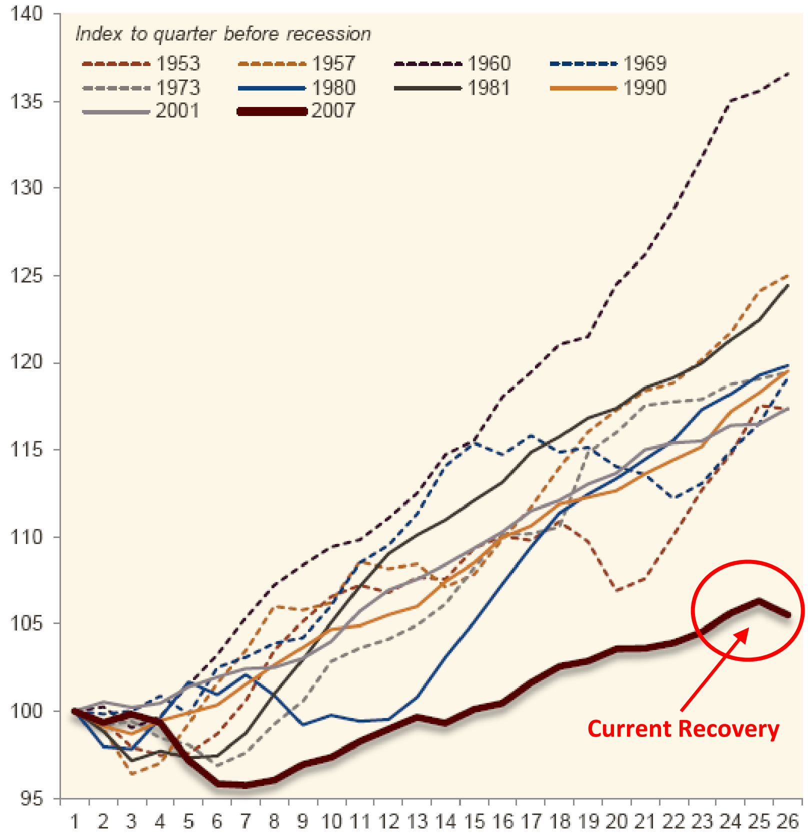
This chart reaffirms why the Fed has kept interest rates low for such a long period, and is supportive of a gradual rise in interest rates as opposed to a sharp rise that could unsettle the broader economy and markets.

Some would argue this chart suggests that the unprecedented amount of QE has not worked for the real underlying economy, and has only resulted in higher asset prices which have the potential to create asset class 'bubbles'.

With much hinging on the US Fed successfully navigating these uncharted waters, investors should remain alert, particularly when low volatility may be hiding some of the underlying risks within the market.

In the current environment, investors should be focused on **risk adjusted returns** as opposed to 'returns', bearing in mind the following questions:

US GDP Growth Continues to Track Below Equivalent Points in Past Recoveries



The vertical axis shows growth in US GDP over quarterly time periods.

- What are my objectives: wealth accumulation, capital preservation, income or growth?
- Do I understand the likely outcomes from my portfolio in various market cycles?
- Am I being rewarded sufficiently for taking on additional investment risk?

- Does my portfolio display underlying diversification in volatile market periods?
- What risks am I prepared to accept and what risks do I want to hedge away?
- Am I overpaying for yield and underestimating the associated risk of capital loss?
- What other investment strategies provide robust risk adjusted return profiles?

Some of the signals we are seeing in the market right now warrant taking a more cautious approach, with emphasis not only on market upside, but also on managing market downside risk. Whilst it could be argued that a market correction is long overdue, the challenge for investors is that the timing and magnitude of any potential market correction is unknown. Therefore, we believe it is prudent to have some **downside risk protection strategies** already built into your portfolio.

This article was researched and written by Chris Molloy, Morrows' Chief Investment Officer and Australian Hedge Fund Adviser of the Year 2014. To speak to Chris or another of our Investment Specialists, please contact Morrows on 03 9690 5700.

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