Fed rate hikes
Portfolio Discussion | U.S. 2Q | 2015

After a brutal recession and a painfully slow recovery, the U.S. economy is finally beginning to strengthen. With this recovery, however, comes the need for Federal Reserve (Fed) policy makers to begin to return monetary policy to normal—a prospect that has created consternation and angst among investors.

The Fed is considering a rate hike because the economy is healthier

- In 2008 and 2009, the U.S. economy was in dire straits. The “Great Recession” took a huge toll, with many economic measures, including jobs, housing and business spending, hitting record lows.
- Six years later, the economy has made significant progress.
- Today, the economy is healthier than it was before the crisis, suggesting that the emergency level of monetary medicine administered by the Fed is no longer warranted or appropriate.

Stocks have demonstrated an ability to tolerate rate hikes in the past

- In the last three Fed rate-hiking cycles, “liftoff” was accompanied with some volatility. Volatility would not be surprising this time around either.
- Following some initial bumps, equities have tended to perform fairly well during rate-hike cycles, largely due to a strengthening economy.
- Fixed income has been a bit trickier with mixed results. Investors should be well diversified to prepare for a range of outcomes.

Mind the gap between the Fed’s and the market’s expectations

- While the Fed’s own projections are for a slow and gradual rate-hiking cycle, futures pricing suggests that the market thinks rate hikes will be even slower.
- The gap between the Fed’s projections and the market’s view creates room for surprises and volatility.
- Investors should brace for some turbulence around liftoff by maintaining a well-balanced and diversified portfolio.
Investment implications

• Rate hikes are not a reason to abandon equities. Investors, however, should brace for potential volatility at the Fed’s first rate hike.

• Fixed income investors can expect the short end of the yield curve to rise as bondholders sell short-dated bonds in anticipation of a Fed rate hike. Longer-dated bonds may still benefit from continued demand for duration.

• Investors should remember that the Fed is only considering rate hikes because the economy is healthier than it has been. In general, this is good news.

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