Registered Investment Advisor Firm

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"One Often Meets His Destiny On The Road He Takes To Avoid It." — Master Oogway, "Kung Fu Panda"

One of my loyal readers came through with some great questions from last month's newsletter. To try to answer them in the forum would have made this month's edition too long, so I'll attempt to do it justice and make them this month's theme.

The questions were:

1. How is Janet Yellen going to address the unwinding of QE? What effect will that have on those of us who are retired and invested in the stock market?
2. What about these national defaults? Greece, and who else? What actions should we consider?
3. What effect is the new trade policy going to have, and on what sectors of the economy?

Fortunately I see a common thread running through these 3 questions which makes addressing them a little easier.

To start, I see both the Greek "crisis" and the Chinese market freefall as local issues which are likely to have minimal impact on the US markets as a whole.

Further, both issues are being addressed to minimize broad damage (to Europe for the Greek concern and to the Communist party and the Chinese citizenry with respect to the China stock market issue).

I don't want to understate the potential for near-term volatility, which could be significant, especially for certain stocks with direct exposure to China, or to Greek loans. In those instances you could see some material impact.

The Puerto Rico debt debacle is just noise. Both Houston and Boston have a larger GDP than Puerto Rico and the President has indicated there will be no bailout. I expect to see a modification to

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Chapter 9 bankruptcy rules to allow a U.S. territory to restructure their debt.

I don't believe that the US market as a whole should not expect to see long-lasting, material damage from these incidents.

That brings us to the 800 pound gorilla in the room (No! This is NOT a reference to the Fed Chairman – but to the theme of the first question)

It's no secret that investors have long anticipated the moment when the Fed will increase interest rates. The soft tone to U.S. first-quarter economic data coupled with below-target inflation has provided the Fed with substantial latitude as to when to start raising short-term interest rates.

However, given that the U.S. is creating jobs at the fastest pace since the late 1990s coupled with the risks that ultralow rates pose to financial stability, it is becoming more and more difficult to justify a 0% policy rate.

As such, the pace of monetary tightening is likely to be gradual, the Fed should start to remove monetary accommodation later this year.

The question then becomes what will be the impact of the Fed moves, particularly for equities?

In assessing the impact of the first rate increase, it is worth restating just how unusual the current rate environment is. While the Fed has caused several easing cycles over the past 60 years, none of those previous cycles have ever brought rates to these low levels.

That said, over longer horizons, markets characterized by price to earnings (P/E) expansion are more vulnerable to a tightening cycle.

Historically over 6 and 12 months, the S&P 500 has performed much worse following the start of a tightening cycle if P/E valuations had been rising in the previous year. U.S. equity market valuations have been consistently rising since 2011, so this might give certain investors pause.

There's more – while the relationship between changes in monetary conditions and market performance appears fairly enduring it is not entirely clear what accounts for it.

One could expect that rising rates should have a negative impact on margins and profitability, thus lowering earnings. In addition, rising rates could also have a negative impact by hurting end-user demand.

When it comes to P/E expansions, higher rates negatively impact stocks by raising the discount rate on future cash flows, in turn lowering the P/E ratio.

I never said this would be easy. If you accept the theory that higher rates are associated with lower profitability, historically we see exactly the opposite.

Looking back over the past 25 years, periods of higher real rates have generally been associated with higher

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profitability, measured by the return-on-equity (ROE) for the S&P 500.

At least historically over this timeframe, the relationship has been fairly strong. As a rough rule of thumb, for each percentage point the real (experienced) Fed Funds rate rises, ROE typically increases by roughly two percentage points.

While this at first might seem counterintuitive, it is not too difficult to explain.

Rising real rates typically occur in the context of an accelerating economy. So an improving economy is lifting earnings, real rates and profits can rise together. Both are responding to the same underlying force of a stronger economy.

To the extent that we see a negative relationship between real rates and equity returns, this seems to be a function of how investors value companies.

Historically, rising real rates have been followed by periods of multiple (P/E) contraction, while falling real rates have generally been followed by periods of P/E expansion.

This is certainly consistent with what we have seen over the past six years. As real rates have dropped and remained at record lows, P/E multiples have steadily increased.

The relationship between changes in the real Fed Funds rate and changes in P/E multiples tracks the situation with total returns.

This same assumption holds for small caps, only more so. While small-cap earnings are likely to hold up better in a rising dollar environment due to lower exposure to international sales, if the reason the dollar is rising is tighter monetary policy, small-caps may not offer much in the way of defense.

Periods in which monetary conditions are easing tend to produce a "risk-on" mentality, benefiting the asset class even more than larger companies, as small-cap stocks tend to be more speculative.

Conversely, as monetary accommodation is removed and rates rise, the impact also tends to be disproportionate.

In the year following a rise in the real Fed Funds rate, small-cap multiples are roughly 2.2 times more likely to shrink in the year following a rise, measured as the year-over-year change in the real Fed Funds rate.

This may be a particular risk today as small-cap valuations have once again been on the rise. After falling for most of the past year, the Russell 2000 (small-cap benchmark) is trading at roughly 47 times trailing earnings. This represents an approximate 20% rise from last fall's bottom in valuations.

A normalization in U.S. monetary policy is unlikely to foreshadow a catastrophe.

The Fed is likely to take a slow and measured path, while factors such as

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slower growth, demographics, and technology are all conspiring to keep rates down. I believe both nominal (stated) and real rates will remain low for the foreseeable future.

This is likely to change as investors become reacquainted with what a tightening cycle feels like.

While the cycle is expected to be gentle, it will also be unorthodox. This adds another layer of uncertainty as both the Fed and investors adapt to unfamiliar tools and how to remove accommodation under the overhang of a bloated balance sheet.

Starting this fall, investors should, at the very least, expect more volatility and a heightened likelihood of a correction.

With respect the "new trade policy," the proposed legislation is far from settled, so it would be premature to speculate on both impact and sectors.

Not the end of the world, but a long overdue correction.

Answer Forum

Hopefully addressed above!

Davis Investment Group

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Davis Investment Group's home office is located at 714 Marin Street, Suite #C, Vallejo, CA 94590. The telephone number is (707) 648-2024.

If you have questions or would like further information on this month's topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me directly at (925) 360-6819 or through my email address at: Bud@DavisInvestmentGroup.biz

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