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INSIGHTS

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2016: Ten Predictions to Count On

January 12, 2016
By: Jim Parker,
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The New Year is a customary time to speculate. In a digital age, when past forecasts are available online, market and media professionals find it harder to hide their blushes when their financial predictions go awry. But there are ways around that.

The ignominy that goes with making bold forecasts was highlighted in a recent newspaper article, which listed many bad calls US economists had made about 2015. These included getting the timing of the Federal Reserve's interest rate increase wrong, incorrectly calling for a rise in long-term bond yields, and assuming an end to the commodity rout.[1]

For the broad US equity market, 22 strategists polled by the Wall Street Journal[2] estimated an average increase for the S&P 500 of 8.2% for 2015. The most optimistic individual forecast was for a rise of 14%. The least optimistic was 2%. No one picked a fall. As it turned out, the benchmark ended marginally lower for the year.

In the UK, a poll of 49 fund managers, traders, and strategists published in early January 2015 forecast that the FTSE 100 index would be at 6,800 by midyear and 7,000 points by year-end. As it turned out, the FTSE surpassed that year-end target by late April to hit a record high of 7,103 before retracing to 6,242 by year-end.[3]

Australian economists were little better. The consensus view, according to a January 2015 Fairfax Media poll, was that local official interest rates would stay on hold all year. The Reserve Bank of Australia proved that wrong a month later, before cutting rates again in May.

It shouldn't be a surprise that if economists can't get the broad variables right, it must be tough for stock analysts to pick winners. Even a stock like Apple, which for so many years surprised on the upside, disappointed some forecasters last year with a 4.6% decline.[4]

In Australia, the "Top Picks for 2015" published by one media outlet a year ago included such names as Woodside Petroleum, BHP Billiton, Origin Energy, and Slater & Gordon, all of which suffered double-digit losses in the past year.[5]

It should be evident by now that setting your investment course based on someone's stock picks or expectations for interest rates, the economy, or currencies is not a viable way of building wealth in the long term. Markets have a way of confounding your expectations. So a better option is to stay broadly diversified and, with the help of an advisor, set an

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A Personal Note From Global Wealth Advisors

The first six weeks of this year reminded us that equity investment returns can and will be volatile. The major U.S. indexes were down approximately 8% to 14%, the foreign MSCI EAFE index was down almost 13% and the emerging markets MSCI EM index was down around 10%. Many analysts blamed the losses on falling oil prices, a slowing Chinese economy, a strong dollar and uncertainty on Fed interest rate hikes.

However, in the ensuing six weeks, those same equity indexes reversed direction and added back about ten percentage points to the year-to-date returns. Those same analysts were crediting these increases to the rising price of oil, easing concerns over the Chinese economy, a weakening dollar and expectations that the Fed would not raise interest rates in the near-term.

As a few of the articles in this newsletter remind us, equity markets are unpredictable and experience short-term volatility. But over the long-term, it is that risk and uncertainty that provides the equity return premium over lower yielding fixed investments like Treasury Bills, certificates of deposit or bank savings accounts. As the saying goes, there are no free lunches in the markets but history has shown us that, over the long run, risk is usually rewarded.

Jim Knaus *Mike Krencicki*

How Does the Federal Reserve Raise Interest Rates?

February 16, 2016
By Alina Lamy,
Morningstar® ARC

Many investors understand some of the basic effects that rising interest rates have. Higher rates ultimately benefit savers, because rates on savings accounts, money markets, and CDs trend higher. But the prices of longer-dated bonds, which have an inverse relationship with rates, fall. Borrowing costs will rise when interest rates go up, too. That has an impact on businesses that borrow money to fund their operations and grow, and it also affects consumers as the rates on many consumer loans, such as home-equity loans, credit cards, and auto loans, tend to rise.

But the lesser-known element is what goes on behind the scenes when the Federal Open Market Committee decides to raise or lower its target interest rate. The Fed doesn't simply declare that a new higher or lower rate is in effect and leave it at that; rather, to achieve its monetary policy goals, it uses the tools it has at its disposal to take action that results in changes in the rates we see in the market. And this time, the actions it will take, and the tools it will use, will be much different from the ones it has used in the past.

The Fed's Traditional Tools

In the era before the financial crisis, the Fed would primarily influence rates in the market by adjusting the quantity of reserves in the banking system, which kept the federal-funds rate, the interest rate at which banks lend to each other overnight, around the target established by the FOMC.

One of the most common tools that the Fed used to accomplish this feat is what is known as 'open-market operations', in which the Fed buys and sells Treasury securities in the open market. When the Fed buys Treasuries, it pays the seller, which increases the reserves in the banking system. The more plentiful banks' reserves, the more money is available to loan, which puts downward pressure on the federal-funds rate. When the Fed is selling securities, conversely, it is reducing reserves in the banking system (because the buyers are paying the Fed for the assets), raising rates.

The goal of open-market operations was to set the quantity of reserves in the system equal to the quantity demanded by the banks at the target rate of interest, explains Julian Potenza, a macro/asset allocation analyst at Fidelity. 'By making precise adjustments to the quantity of reserves in the system, the Fed was able to exercise very tight control over the federal-funds rate and was able to keep that market perfectly balanced so that the quantity of reserves in the system was exactly the same as banks' demand at the Fed's objective target interest rate,' Potenza said.

Why It's Different This Time Around

Today, the Fed's balance sheet looks much different from how it did prior to the financial crisis. After purchasing trillions of dollars of assets as a result of quantitative-easing programs, the size of the Fed's balance sheet is now around $4.5 trillion, as opposed to in the $800 billion range prior to the crisis.

The effect of the Fed's asset-buying programs is that the financial system is awash with reserves, and this delicate balance is a thing of the past. The Fed likely doesn't want to sell the assets on its balance sheet immediately, presumably, because it doesn't want to unravel everything that was accomplished by quantitative easing in the first place. Selling too many financial assets in too short a period of time could put too much upward pressure on interest rates and cause financial conditions to tighten too much, and could have a destabilizing effect on the bond market.

So, the Fed is now faced with a new challenge: It needs to raise short-term rates in the market without selling its own securities holdings, and without reducing the level of reserves held by banks.

Indeed, the Fed has said that it intends to achieve its target range for the federal-funds rate 'not by actively managing the Federal Reserve's balance sheet.' Rather, it will use some new tools this time, which it said will allow it to raise short-term interest rates and 'to maintain reasonable control of the level of short-term interest rates as policy continues to firm thereafter,' even though the level of reserves held by banks is likely to diminish only gradually.

The New Tools

Since October 2008, the Fed has been paying banks interest on their reserve balances. According to the Fed, increasing the rate of interest paid on excess reserves, or IOER, will be the primary means of raising the federal-funds rate when a decision is made to raise the target range. Currently, this rate is 25 basis points (or 0.25%), and it is expected that this rate will go up to 50 basis points when the Fed decides to raise rates.

'Instead of setting the fed-funds rate by adjusting the quantity of reserves in the system, they've decided to put a price on those reserves directly by paying banks, currently, 25 basis points for the reserves that they hold,' Potenza said.

The idea behind the interest on excess reserves is that it would put a 'floor' on short-term rates; banks would not be expected to lend to a higher-credit-risk counterparty at less than the

25-basis-point rate it could earn for lending to the Fed, which is a riskless counterparty.

And that certainly makes sense; however, there are plenty of nonbanks that would lend for less. The IOER is only available to 'depositary institutions', in other words, banks. It's not available to nonbank institutions that are significant lenders in the financial system, such as money market funds and government-sponsored enterprises (GSEs).

'The IOER was providing a very leaky floor for the Fed to be relying on as a tool to raise rates. The core reason for that was because it was only available to a subset of counterparties, namely the banking system,' said Potenza.

Reinforcing the Floor

To address this problem, the Fed plans to use another tool known as overnight reverse repurchase agreements, or 'reverse repos.' In an overnight reverse repo operation, the Fed is essentially allowing nonbank counterparties (GSEs or money market funds, for example) to make collateralized loans to the Fed at a fixed interest rate.

In theory, reverse repos (RRPs) should work the same way as the IOER rate to set a floor under short-term interest rates, because they would discourage loans to riskier counterparties at less than the RRP rate. The RRPs, in combination with the IOER, should then, theoretically, reinforce the short-term rate floor.

Currently, this RRP program has an aggregate cap of $300 billion, but the Fed has indicated that it would be willing to expand the program if necessary. The key, according to Potenza, will be to supply RRPs in sufficient quantity. 'If they don't size it right relative to the demand, it might not serve as the kind of firm floor that they were hoping for.' ●

This article contains certain forward-looking statements which involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially from any future results expressed or implied by those projected statements. Past performance does not guarantee future results. Karen Wallace, senior editor with Morningstar, contributed to this article.

Should Investors Sell After a "Correction"?

September15, 2015
By: Weston Wellington,
VP Dimensional Fund Advisors

Stock prices in markets around the world fluctuated dramatically for the week ended August 27. On Monday, August 24, the Dow Jones Industrial Average fell 1,089 points—a larger loss than the "Flash Crash" in May 2010—before rallying to close down 588. Prices fell further on Tuesday before recovering sharply on Wednesday, Thursday, and Friday. Although the S&P 500 and Dow Jones Industrial Average rose 0.9% and 1.1%, respectively, for the week, many investors found the dramatic day-to-day fluctuations unsettling.

Based on closing prices, the S&P 500 Index declined 12.35% from its record high of 2130.82 on May 21 through August 24. Financial professionals generally describe any decline of 10% or more from a previous peak as a "correction," although it is unclear what investors should do with this information. Should they seek to protect themselves from further declines by selling, or should they consider it an opportunity to purchase stocks at more favorable prices?

Based on S&P 500 data, stock prices have declined 10% or more on 28 occasions between January 1926 and June 2015. Obviously, every decline of 20% or 30% or 40% began with a decline of 10%. As a result, some investors believe that avoiding large losses can be accomplished easily by eliminating equity exposure entirely once the 10% threshold has been breached.

Market timing is a seductive strategy. If we could sell stocks prior to a substantial decline and hold cash instead, our long-run returns could be exponentially higher. But successful market timing is a two-step process: determining when to sell stocks and when to buy them back. Avoiding short-term losses runs the risk of avoiding even larger long-term gains. Regardless of whether stock prices have advanced 10% or declined 10% from a previous level, they always reflect (1) the collective assessment of the future by millions of market participants and (2) the expectation that equities in both the US and markets around the world have positive expected returns.

Exhibit 1 on the following page shows that US stocks have typically delivered above-average returns over one, three, and five years following consecutive negative return days resulting in a 10% or more decline. Results from non-US markets are similar.

Contrary to the beliefs of some investors, dramatic changes in security prices are not a sign that the financial system is broken but rather what we would expect to see if markets are working properly. The world is an uncertain place. The role of securities markets is to reflect new developments— both positive and negative—in security prices as quickly as possible. Investors who accept dramatic price fluctuations as a characteristic of liquid markets may have a distinct advantage over those who are easily frightened or confused by day-to-day events and are more likely to achieve long-run investing success. ●

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"Wild Ride Leaves Investors Grasping," Wall Street Journal, August 25, 2015.

"Investors Scramble as Stocks Swing," Wall Street Journal, August 25, 2015.

Exhibit 1: Returns after Corrections

US LARGE CAP: JANUARY 1926–JUNE 2015				Annualized Compound Return		
Cutoff for Decline	Frequency of Such Declines	Avg. Horizon for Decline (Trading Days)	Avg. Magnitude of Decline	for Next 1 Year	for Next 3 Years	for Next 5 Years
5%	262	4.1	–7.55%	13.24%	9.43%	10.02%
10%	28	4.6	–14.25%	23.56%	8.89%	13.33%
Unconditional annualized compound return for full sample is 9.32%.						

INTERNATIONAL LARGE CAP: JANUARY 2001–JUNE 2015				Annualized Compound Return		
Cutoff for Decline	Frequency of Such Declines	Avg. Horizon for Decline (Trading Days)	Avg. Magnitude of Decline	for Next 1 Year	for Next 3 Years	for Next 5 Years
5%	58	4.8	–7.71%	17.30%	9.03%	9.38%
10%	9	5.6	–13.33%	24.73%	12.69%	12.89%
Unconditional annualized compound return for full sample is 4.05%.						

EMERGING MARKETS: JANUARY 1999–JUNE 2015				Annualized Compound Return		
Cutoff for Decline	Frequency of Such Declines	Avg. Horizon for Decline (Trading Days)	Avg. Magnitude of Decline	for Next 1 Year	for Next 3 Years	for Next 5 Years
5%	74	4.8	–8.12%	24.82%	11.84%	10.33%
10%	15	5.5	–14.04%	42.23%	13.36%	11.20%
Unconditional annualized compound return for full sample is 9.49%.						

Declines are defined as periods with consecutive days of negative index returns with cumulative losses at or above the cutoff. Annualized compound returns are averages across all declines. US Large Cap is the S&P 500 Index, provided by Standard & Poor's Index Services Group. International Large Cap is the MSCI World ex USA Index. Emerging Markets is the MSCI Emerging Markets Index. MSCI data © MSCI 2014, all rights reserved. Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

2016: Ten Predictions to Count On

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asset allocation that matches your own risk appetite, goals, and circumstances.

Of course, this approach doesn't stop you or anyone else from having or expressing an opinion about the future. We are all free to speculate about what might happen in the economy and markets. The danger comes when you base your investment strategy on such opinions. In the meantime, if you insist on following forecasts, here is a list of 10 predictions you can count on coming true in 2016:

1. Markets will go up some of the time and down some of the time.
2. There will be unexpected news. Some of this will move prices.
3. Acres of newsprint will be devoted to the likely path of interest rates.
4. Acres more will speculate on China's growth outlook.
5. TV pundits will frequently and loudly debate short-term market direction.
6. Some economies will strengthen. Others will weaken. These change year to year.
7. Some companies will prosper. Others will falter. These change year to year.
8. Parts of your portfolio will do better than other parts. We don't know which.
9. A new book will say the rules no longer work and everything has changed.
10. Another new book will say nothing has really changed and the old rules still apply.

You can see from that list that if forecasts are so hard to get right, you are better off keeping them as generic as possible. Like a weather forecaster predicting wind, hail, heat, and cold over a single day, your audience should prepare themselves for all climates.

The future is always uncertain. There are always unexpected events. Some will turn out worse than you expect; others will turn out better. The only sustainable approach to that uncertainty is to focus on what you can control. ●

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4. "Seven Stocks to Buy for 2015," CNN Money, December 31, 2014.
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