Fed rate hikes

Portfolio Discussion | U.S.

2Q | 2017

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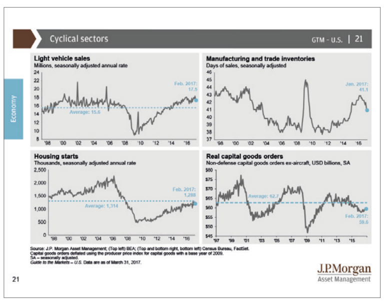

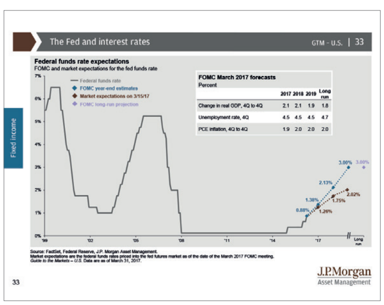

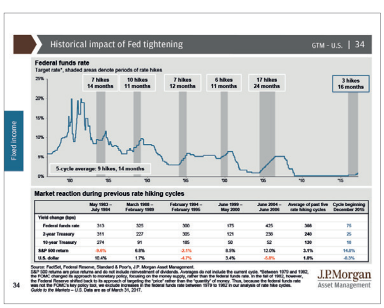

After a brutal recession and a painfully slow recovery, the U.S. economy no longer needs emergency measures of support from the U.S. Federal Reserve. Policymakers began the process of normalizing monetary policy at the end of 2015, and although the Fed is raising rates because the economy is healthier, the prospect of higher rates has created consternation and angst among some investors.

The Fed has hiked interest rates because the economy is healthier

- In 2008 and 2009, the U.S. economy was in dire straits. The "Great Recession" took a huge toll, resulting in significant weakness across a range of economic measures, including jobs, housing and business spending.
- Today, the economy is much healthier than it was during the crisis, suggesting that the emergency level of monetary medicine administered by the Federal Reserve is no longer warranted, or appropriate.

Mind the gap between the Fed and the market

- While the Fed's own projections are for a slow and gradual rate hike cycle, futures pricing suggests that the market thinks rate hikes may be a bit slower.
- Although the gap between the Fed's projections and the market's view has narrowed, there is still room for surprises and volatility. The key thing to watch will be how market expectations adjust to the Fed's new forecasts, as a Fed that hikes more quickly than the market expects could lead to upward pressure on the U.S. dollar and a de facto tightening for the U.S. economy.

Stocks have generally tolerated rate hikes in the past

- As long as a gap between the Fed's expectations and the market's expectations remains, there is a risk of an uptick in volatility.
- However, volatility is normal and should be expected. Furthermore, equities have tended to perform fairly well during past rate hikes, largely reflecting improving economic conditions.
- Fixed income has been a bit trickier. As a result, investors should be well diversified in order to prepare for a range of outcomes, and take advantage of opportunities.

Investment implications

- Rate hikes are not a reason to abandon equities. Investors, however, should prepare for volatility as the Fed initially hikes rates.
- Fixed income investors can expect the short end of the yield curve to rise as the Fed normalizes policy, but longer-dated bond yields should remain low due to continued demand for duration and easy monetary policy abroad.
- Investors should remember that the Fed is only considering rate hikes because the economy is healthier than it was in the aftermath of the crisis. Overall, this is a good thing.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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Unless otherwise stated, all data are as of March 31, 2017 or most recently available.