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Fed tightening begins

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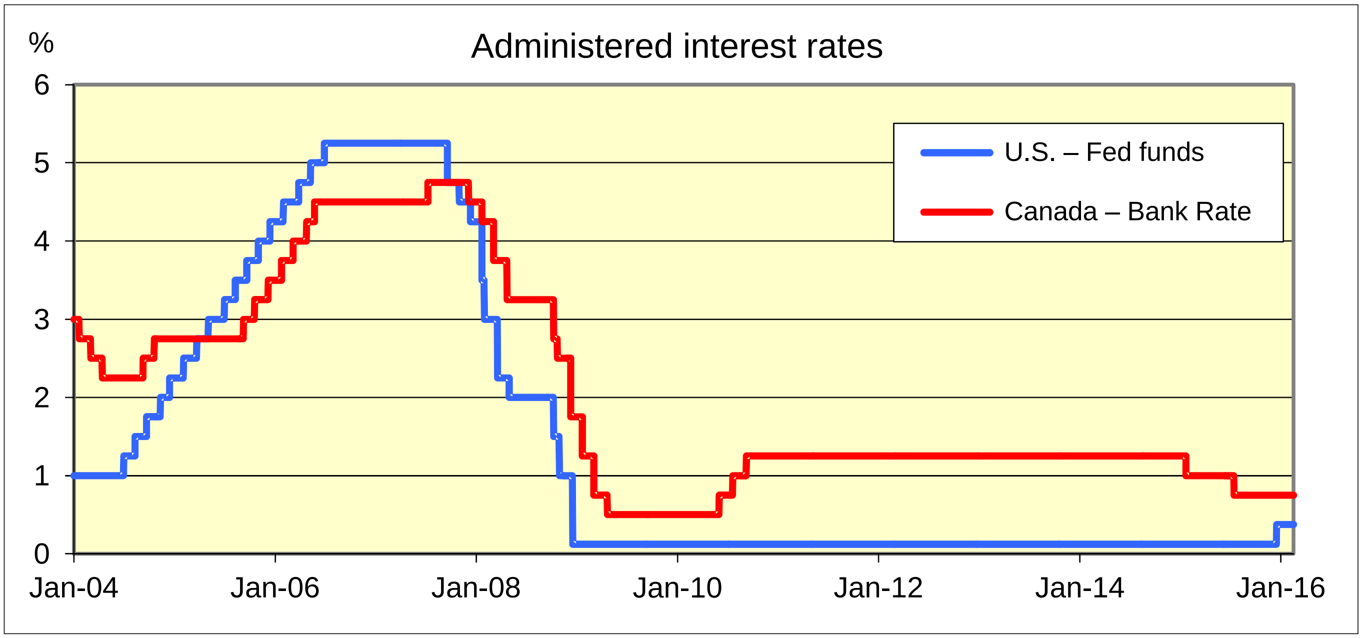
In response to the financial crisis of 2008-09, governments and central banks around the world boosted capital market liquidity to unprecedented levels. Phrases such as troubled asset relief program (TARP) and quantitative easing (QE) became part of the common lexicon. Interest rates fell to historic lows globally, amid efforts to “prime” the economic pump. On December 16, 2015, the U.S. Federal Reserve Board’s Open Market Committee (FOMC) raised interest rates by 25 basis points (a basis point is 1/100th of one percent). This was the first interest rate hike in the U.S. since July 29, 2006. The Fed move ushered in the first tightening cycle in monetary policy since June 2004. For many participants, that 11.5-year stretch represents a significant portion of their own history within the capital markets. For investors, the shift to a different monetary policy stance represents an opportunity to take stock and reflect on their own past experiences. The cyclical nature of the economy, interest rates and the financial markets means that regularly reviewing one’s financial plan and taking advantage of professional advice can help calm jittery nerves amid volatile markets.

Administered interest rates



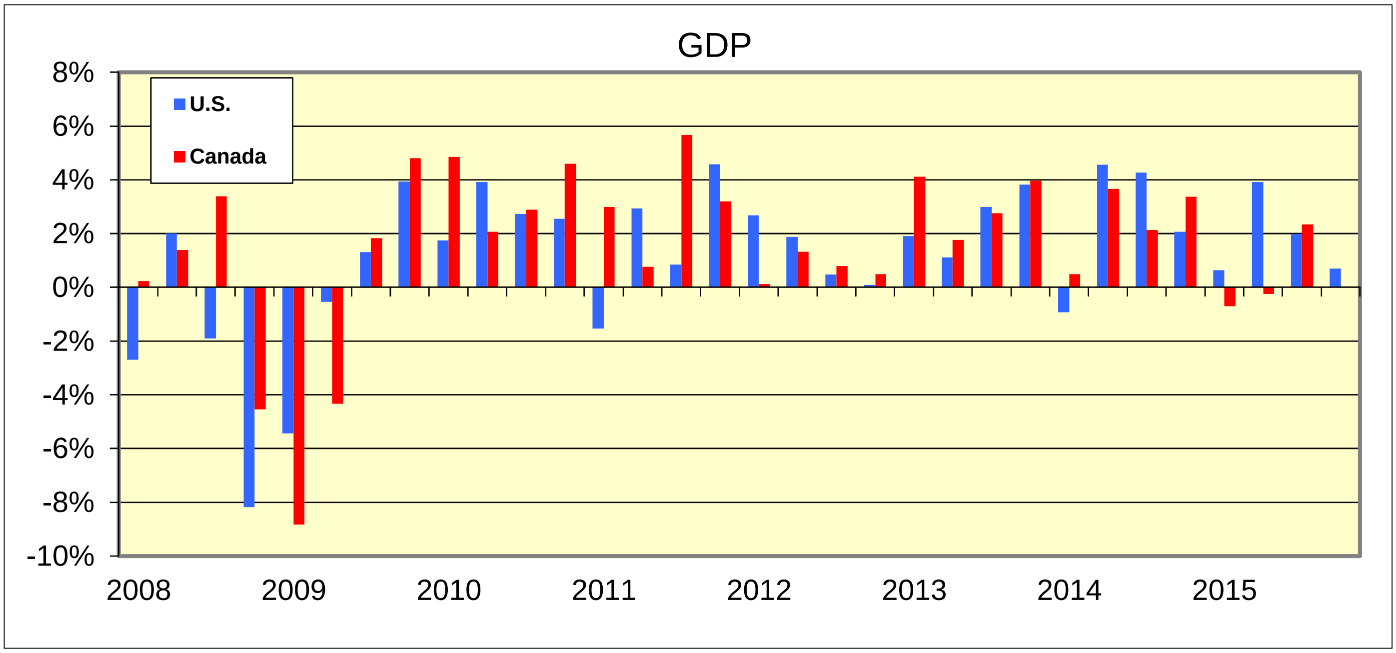
Source: U.S. Federal Reserve; Bank of Canada

While history is known to repeat itself, the circumstances of the current tightening cycle are in some ways different when compared to prior cycles. This time, the benchmark Fed funds overnight rate was at its lowest point in history (in a range of 0.00% to 0.25%) before it was raised. Historically, going back to 1988 in the early stages of Alan Greenspan's era as Fed Chair, the five tightening cycles that preceded the current one began when the interest rate on Fed funds averaged approximately 4.1%. In many ways, the recent hike in interest rates has more to do with returning rates to a "normal" policy footing and less to do with an effort to slow the economy or ease inflationary pressures. In the end, it is likely that this tightening cycle will be cautiously managed by the Fed as it attempts to steer the economy toward a normal interest rate environment while avoiding a material slowdown in growth.

Some analysts would argue that the change in monetary policy began well before the recent interest rate hike. After introducing QE to boost liquidity during the financial crisis, the Fed began to wind up the program in January 2014. It began reducing its monthly purchases of agency mortgage-backed securities to $35 billion per month from $40 billion per month, and reducing its purchases of longer-term Treasury securities to $40 billion per month from $45 billion per month. The reduction in asset buying was continued with subsequent reductions until the program was finally concluded at the October 29, 2014 FOMC meeting.

Broader economy

The most recent U.S. statistics show GDP growth at a very modest 0.7% seasonally adjusted, annualized pace in the final quarter of 2015. However, the latest available data at the time the rate hike took place was for the third quarter of 2015. This was a far more robust 2.0% (on the same basis). Still, it is not the type of growth rate that typically prompts concerns over capacity constraints that could influence the broader economy. From a historical perspective, the 2.0% growth rate compares to an average GDP growth rate of 4.4% seen in the quarter that preceded the five prior tightening cycles. Current economic growth is well below the historic average. As can be seen in the graph below, GDP growth in Canada, which historically has closely tracked its U.S. counterpart, has diverged in the recent past. Much of the damage seen in the U.S. as a result of the sub-prime mortgage issues inflicted considerably less harm here. Conversely, the recent precipitous drop in energy prices has produced a far more pronounced drag on the domestic economy. Looking back, an average GDP growth rate of 4.1% was seen in Canada during the quarter that preceded the five prior U.S. tightening cycles, similar to the U.S. figures.



Source: U.S. Bureau of Economic Analysis; Statistics Canada

Bank of Canada

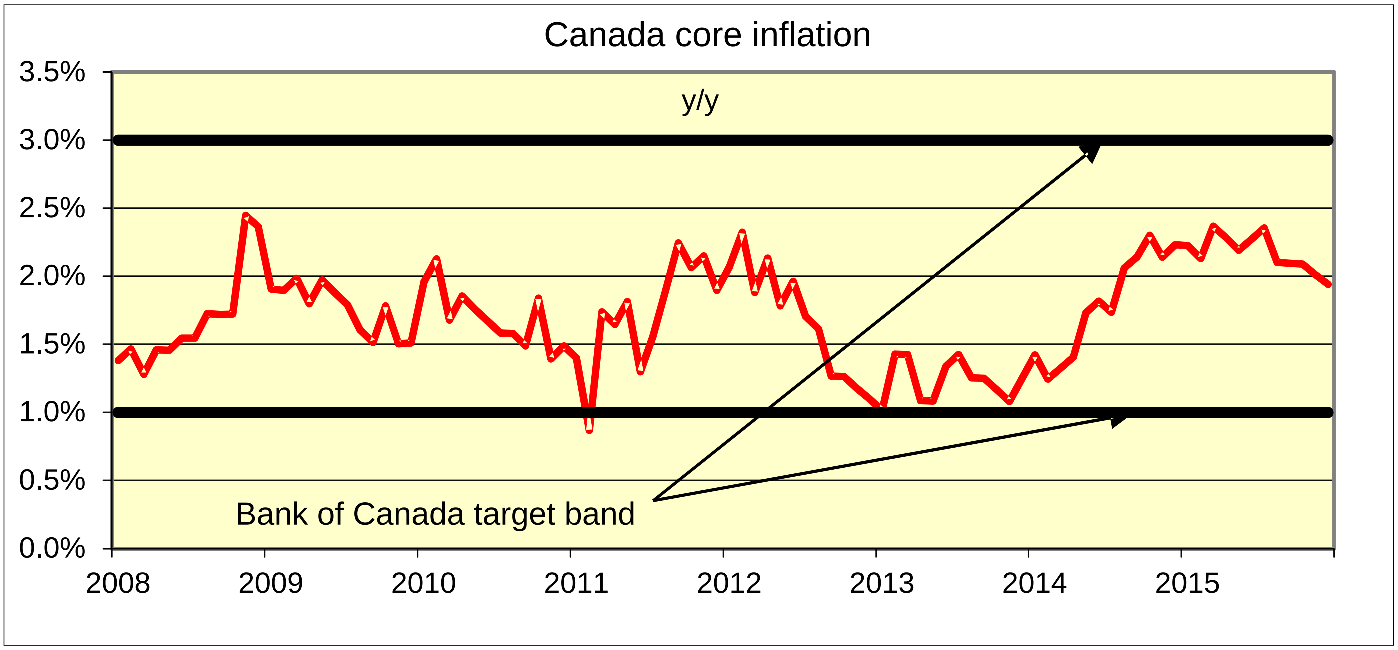
Given the state of the Canadian economy, the Bank of Canada remains firmly planted in the easier monetary policy camp. The bank cut its benchmark interest rate by 25 basis points each on January 21 and July 15, 2015. Canada and the U.S. tend to have economies that move in synch with one another and the present diversion in monetary policy is unusual. Over the past 30 years, there has been only one time, in 1994, when the Bank of Canada cut its interest rate after the Fed increased its rate. That year, the Bank of Canada cut interest rates by 25 basis points twice, while the Fed raised rates by a total of 175 basis points between February and August. Given the weaker economic conditions prevailing in Canada at present, the divergence in monetary policy can be expected to continue, but not indefinitely. Bank of Canada Governor Stephen Poloz has said that there will be times when the respective Canadian and U.S. monetary policies diverge, however, the divergence will usually be temporary.

Inflation

For the vast majority of the world's major central banks, monetary policy is conducted in reference to that nation's inflation. Many, including both the U.S. and Canadian central banks, have explicit inflation targets. The Bank of Canada's published mandate is to:

Monitor a set of "core" inflation measures, including the CPIX[1], which strips out eight of the most volatile consumer price index (CPI) components. These "core" measures allow the Bank to "look through" temporary changes in total CPI inflation and to focus on the underlying trend of inflation, which is a good indicator of where total CPI inflation is headed in the absence of policy action. In this sense, core inflation is monitored as an operational guide to help the Bank achieve the total CPI inflation target, not as a replacement for it.

As can be seen by the graph below, the bank's core inflation rate has remained within the 1.0% to 3.0% target band through virtually the entire post-crisis period, even as other regions flirted with periods of deflation (broad-based price declines).



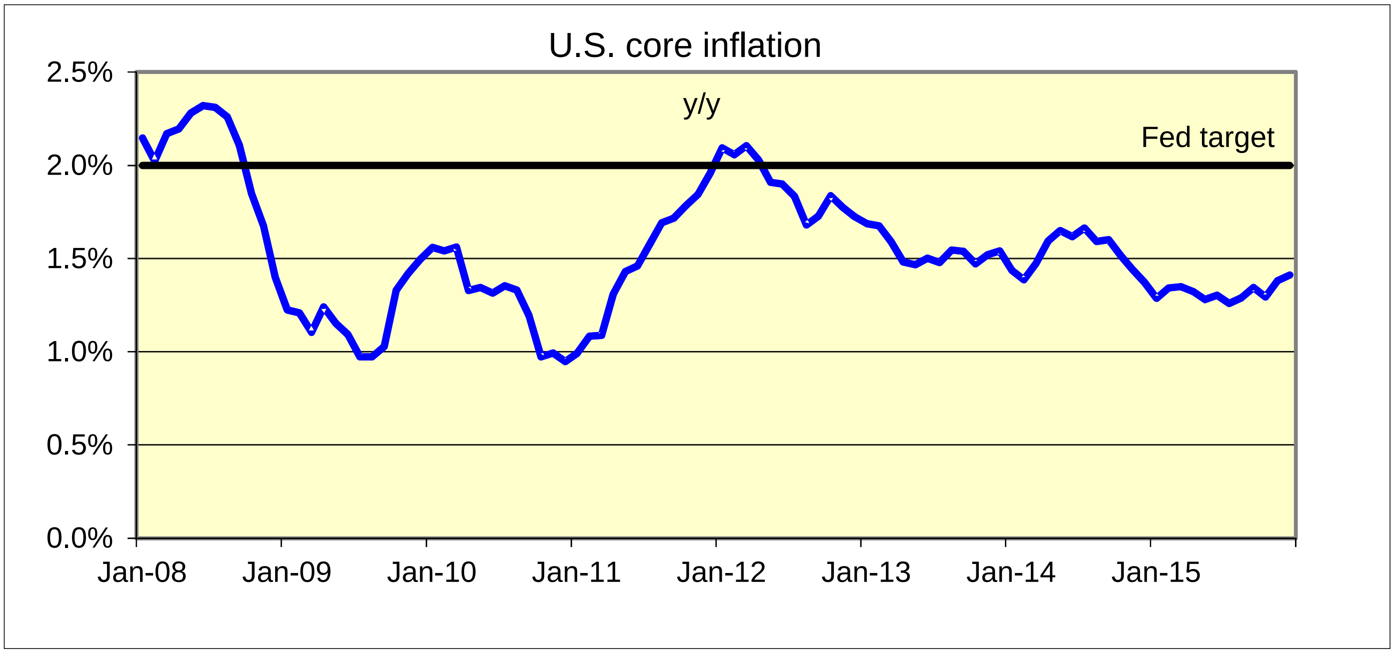
Source: Statistics Canada; Bank of Canada

In the U.S., the Federal Reserve also looks at a specific inflation measure, the PCE core deflator[2], and as can be seen in the accompanying graph, its bogey remains well inside its target. Not surprisingly, since both of these key target measures do not include energy, the recent declines in prices within this sector are not reflected in the two graphs.

In reference to the same five prior tightening cycles initiated by the FOMC, the broader CPI measure, which does include energy, averaged 2.8% (versus 2.2% for the PCE core deflator) over the quarter that preceded the first interest rate hike. During the quarter that preceded the December 16, 2015 move, CPI averaged only 0.1% year-over-year (versus 1.3% for the PCE core deflator). Statistics Canada data show overall CPI

[1] Core CPI or CPIX: The Consumer Price Index excluding eight of the most volatile components (fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation and tobacco products) as well as the effect of changes in indirect taxes on the remaining components.
[2] PCE Core Deflator: Personal Consumption Expenditures, excluding food and energy (chain-type price index)

averaging 1.9% (versus a Bank of Canada core rate of 2.1%) over the same previous five Fed tightenings. During the quarter ahead of the December 16, 2015 rate hike, overall Canadian inflation averaged 1.2% (versus a Bank of Canada core rate of 2.2%). In both countries, inflation and forecasts for inflation suggest little in the way of building price pressures.

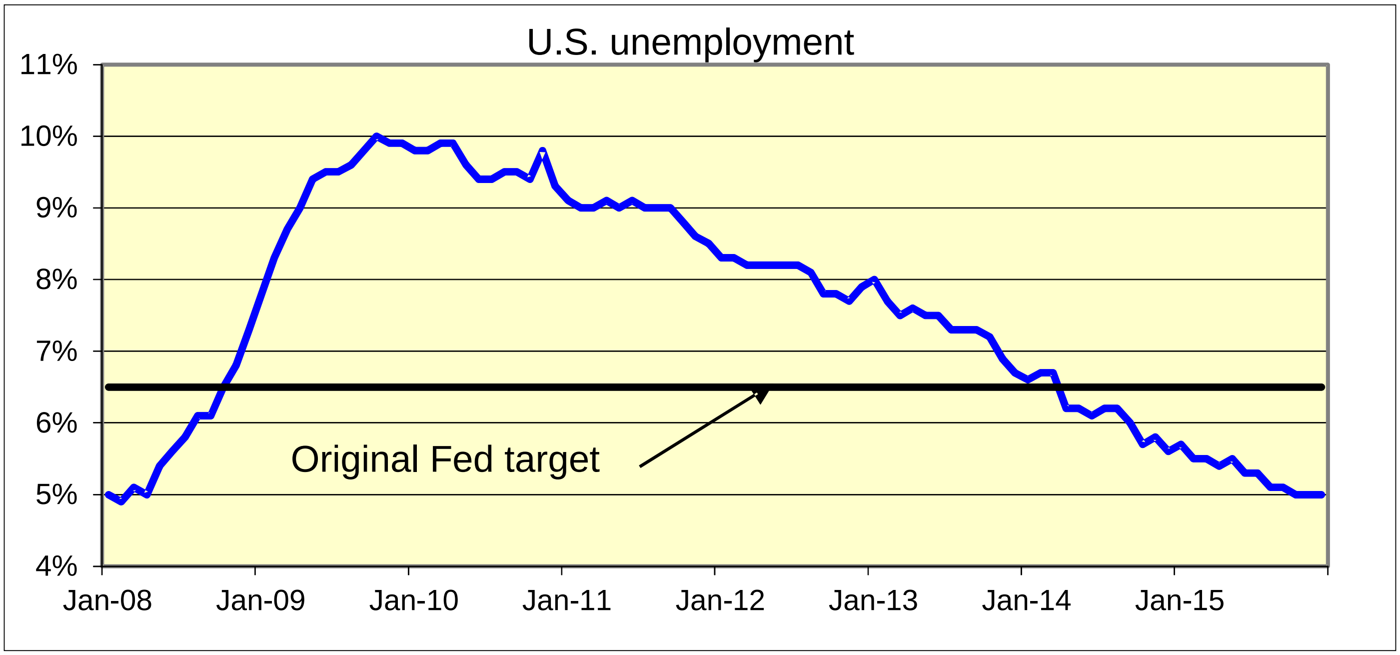


Source: U.S. Bureau of Labor Statistics

Unemployment

Interestingly, while the Fed's adoption of a specific inflation target came well after most other central banks had already done so, its establishment of a mandate related to the unemployment rate provided a second target for market watchers to track. Following a two-day FOMC meeting in December 2012, the committee released a statement indicating that it had decided to keep the target range for the federal funds rate at 0-0.25% and anticipated that the exceptionally low range for the federal funds rate would be appropriate at least as long as the unemployment rate remained above 6.5%, inflation between one and two years from the announcement was projected to be no more than a half percentage point above the committee's 2% longer-run goal, and longer-term inflation expectations continued to be well anchored. Analysts and day-traders alike watched the unemployment rate religiously from that point forward.

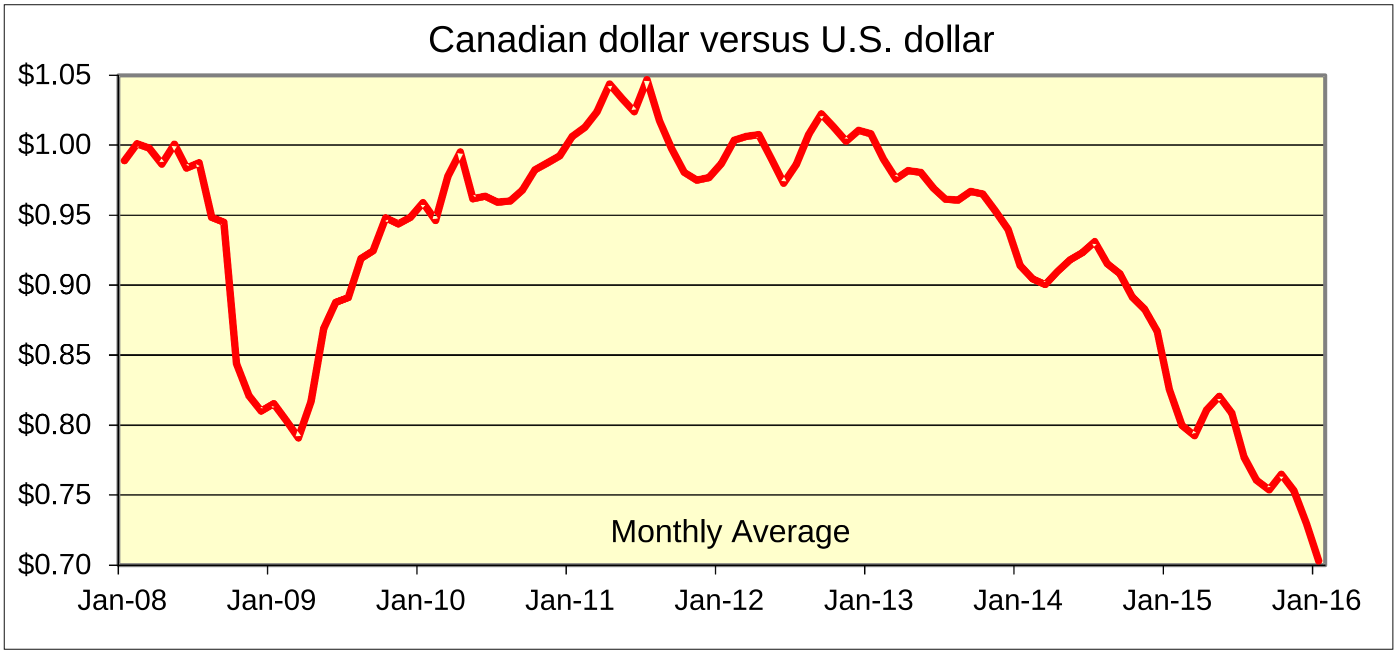
In April 2014, unemployment fell below the 6.5% target, but with virtually no market response. This was in large part due to a shift in focus from the Fed. At the conclusion of the March 18-19, 2014 FOMC meeting, the first under new Fed Chair Janet Yellen's leadership, the Fed dropped its 6.5% unemployment rate threshold. The statement did not represent a return to Alan Greenspan's well-known obfuscation, well characterized by his now-famous quote from a 1988 speech to the Economic Club of New York: "I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said." However, the FOMC's statement did leave some unanswered questions: "With the unemployment rate nearing 6.5%, the Committee has updated its forward guidance. The change in the Committee's guidance does not indicate any change in the Committee's policy intentions as set forth in its recent statements." Regardless of the actual rate of unemployment (4.9% as of January 2016 data), the U.S. labour market does not appear to be "tight" by most accepted standards.



Source: U.S. Bureau of Labor Statistics

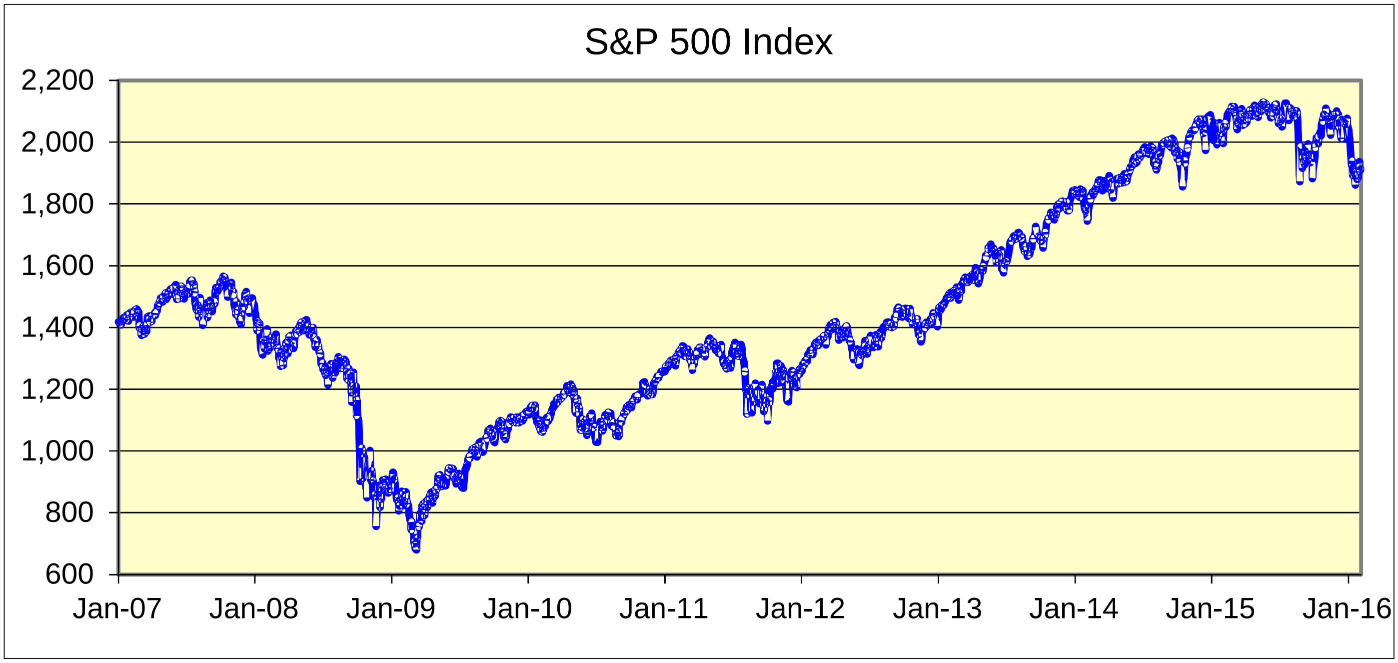
Canadian dollar

The clear divergence in both economic activity and monetary policy within North America has been reflected in the recent market gyrations of the Canadian dollar. The currency has also been influenced by a number of other factors, most notably the price of oil. The confluence of events has been sufficient to drive the loonie as low as US$0.6821, its weakest point since April 9, 2003. Looking back to the previous tightening moves, it had averaged US$0.7383 in the quarter prior to each Fed action. A year after the move, the Canadian dollar had strengthened to an average value of US$0.7480. Interestingly, the average value one year later masks divergent trading patterns in each instance as the Canadian dollar tracked very different paths. Following the 1993 policy move, it weakened by 4.1% over the following 12-month period. Conversely, it gained 9.1% on the heels of the Fed's tightening action in 2004. The other three events represented one gain and two declines.



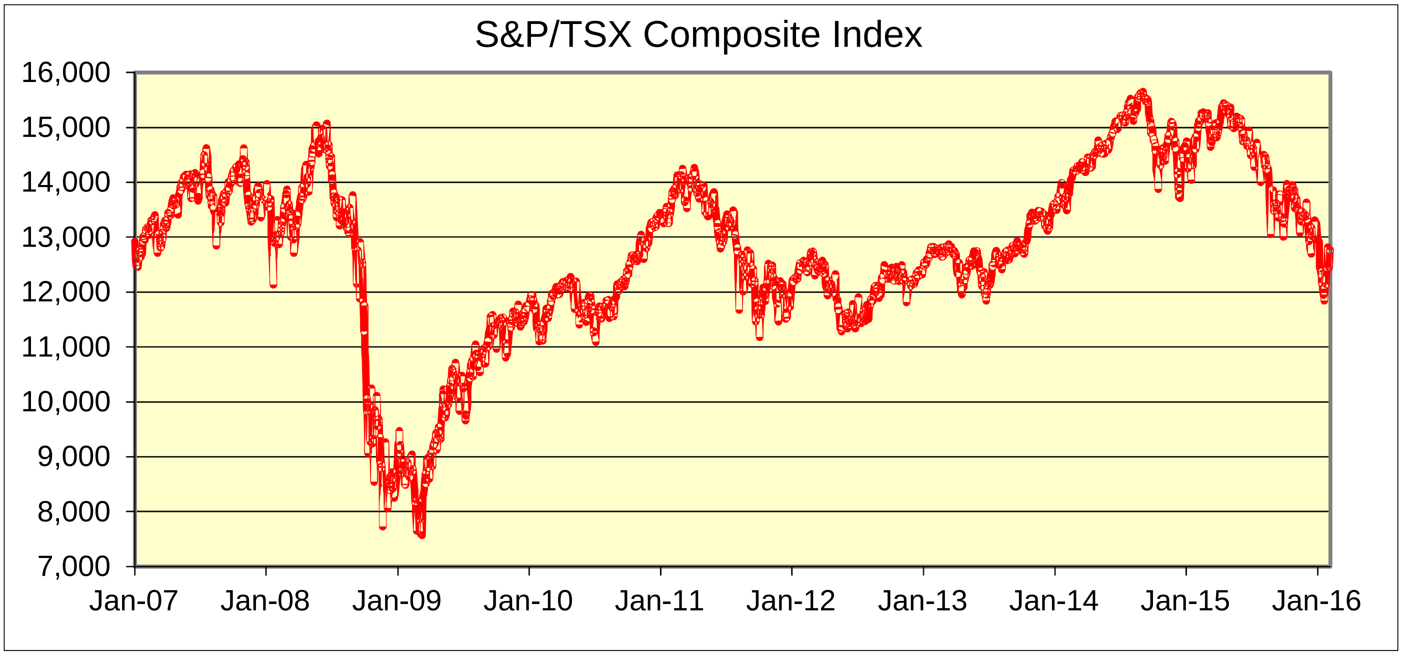
Source: Bank of Canada

Markets



Source: Bloomberg

From an equity market perspective, the most recent rate hike has been followed by international volatility – not all related to this policy action. Still, looking back on the five previous tightening cycles, in each case, one year after the initial rate hike the S&P 500 Index stood with a gain. On average, it was up 13.2%, but it varied from +2.5% in 1994-95 to +39.6% in 1997-98.



Source: Bloomberg

In the domestic market, the pattern was mixed. Even though the one-year interval resulted in an average index gain of 17.0%, the 1994-95 episode had a market decline of 7.4%. At the other end of the scale, the 1999-2000 period saw a market gain of 45.4%. However, even though history has a habit of repeating itself, this tendency cannot be relied upon. Each episode contains circumstances specific to that time. A break in a market trend or a shift in official policy can mark a break in the market. Investors can often find this an opportune time to revisit their financial plan. Making use of professional help can make it easier to stick with that plan as the investing landscape shifts.

Conclusions

- Investors should avoid knee-jerk reactions when economic policy changes. Having the advantage of professional advice allows greater discipline in the investing process.
- The Fed can be expected to be cautious in executing its current monetary policy as the recovery in the world's developed economies remains unsteady. Maintaining a well-diversified portfolio allows investors to take advantage of regional markets that can outperform.
- Divergent monetary policies in the U.S. and here at home can materially influence the value of the currency. Rebalancing and redeploying cash where relative bargains exist can go a long way in bolstering longer-term investment performance.