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WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

September 2015

Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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When money is being passed around in families, it is almost always in one direction -- from older to younger individuals. This article reviews new research on this topic from the Employee Benefit Research Institute.

Weekly Economic Commentary | Week of September 14, 2015

KEY TAKEAWAYS

- Although there is a chance the Fed will raise rates this week, our view remains that the Fed will hike later this year, most likely at the December 2015 meeting.
- While much of the focus has been on "when," market participants may start asking "how much" and "how fast" rates may increase once the Fed begins to raise the rates.
- The current disconnect on the "how much" and "how fast" between the FOMC and the financial markets could be a major issue for financial market participants in the months ahead.

HOW MUCH, HOW FAR, HOW FAST, NOT WHEN?

The policymaking arm of the Federal Reserve (Fed), the Federal Open Market Committee (FOMC), will hold its sixth of eight meetings of the year this week. On Thursday, September 17, 2015, at the conclusion of the two-day meeting, the FOMC will release a statement and a new economic and interest rate forecast. In addition, Fed Chair Janet Yellen will conduct her third post-FOMC meeting press conference of the year. The FOMC will also provide markets with a new set of targets at this meeting, as it does four times a year. The FOMC will release its new forecast for gross domestic product (GDP), the unemployment rate, inflation, the appropriate timing of the first rate hike, and the so-called "dot plot," where each member identifies the appropriate level for the fed funds rate at year-end in 2015, 2016, 2017, and in the "longer run." These data points will be scoured by market participants looking for clues regarding how the FOMC's internal economic forecast has evolved since the last release in June 2015, for clues to future policy, regardless of any decision made this week. The dot plot, in particular the level of the fed funds rate the FOMC sees in the "longer run," may play an important role in this week's meeting if the committee does not raise rates.

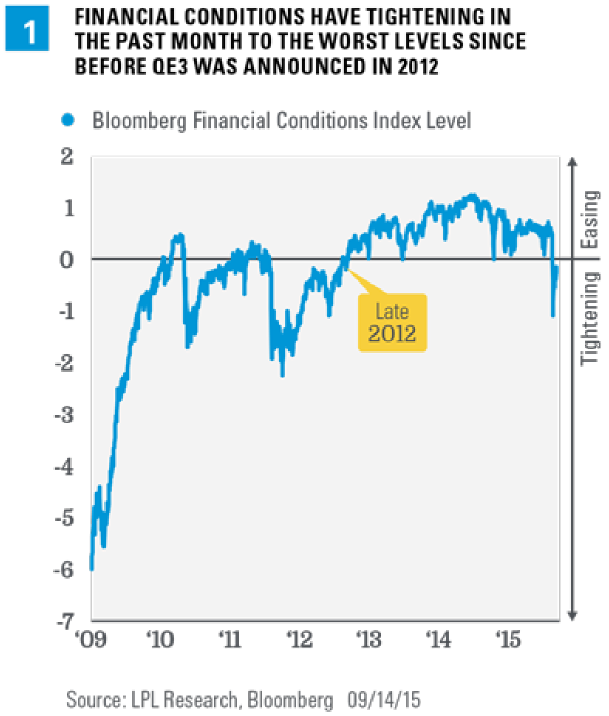
GENERAL DISAGREEMENT

As of Friday, September 11, 2015, most market participants expect the Fed to make no changes to policy this week, although the market--per the fed funds futures contracts--is pricing in about a 1 in 4 chance of a hike this week. However, about half of the 100 or so economists surveyed by Bloomberg News expect the Fed to raise rates this week, but also point out that the yield on the 2-year Treasury note (often a good leading indicator of Fed action) has hovered near 70 basis points (0.70%) since mid-June 2015, an indication that the bond market doesn't expect a move this week. Fed officials have largely been noncommittal on the issue, with the usual FOMC "hawks" (those who usually lean toward the low inflation side of the Fed's dual mandate) eager to raise rates, while the "doves" (those who usually favor the full employment side of the dual mandate) have been saying more time is needed.

Our view remains that the Fed will hike later this year, most likely at the December 2015 meeting. However, the data--especially the inflation data--do not yet support a Fed hike. Why? Since the March 2015 FOMC meeting, the Fed has said: "it will be appropriate to raise the target range for the federal funds rate when it has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term."

While the labor market data do support a hike, inflation has been moving in the wrong direction--lower--in recent months, thanks to another 30% drop in oil prices. In addition, Fed officials have made it clear that they want to be sure the market is fully aware of a rate hike when it comes. With financial markets and Fed watchers conflicted about the outcome of this week's meeting (see above), the timing doesn't seem right, either. Had the data--especially the inflation data--supported a rate hike this week, the Fed likely would not have let the recent turmoil in global financial markets around the Chinese equity markets and economy stand in the way.

Also arguing against a hike this week are financial conditions, as measured by the Bloomberg Financial Conditions Index [Figure 1], which have tightened considerably in the past month. Even after recovering in the past two weeks, financial conditions remain at their worst levels since before the Fed announced quantitative easing 3 (QE3) in September 2012. In effect, the market has tightened on behalf of the Fed in the past four weeks.



IT'S HOW MUCH, HOW FAR, AND HOW FAST, NOT WHEN, THAT MATTERS

While many continue to obsess over the when the Fed's first rate hike will occur, our long-held view is that "how much," "how far," and "how fast" the Fed hikes rates after it starts raising rates will be far more important than "when." Right now, the Fed and the market disagree on nearly everything: when, how much, how far, and how fast, and ironically, the "when" is where there is the most agreement between the Fed and financial markets. As noted above, the market and the Fed are fairly closely aligned on the "when," at most differing by a few months or so. The latest forecast (June 2015) by the FOMC of the timing of its first rate hike says that 15 of the 17 members of the FOMC expect the first hike to occur in 2015, and this timing is largely in line with what economists and financial markets are saying.

But there is still a large discrepancy on the "how much," "how far," and "how fast," and the financial market and, in our view, the U.S. and global economy's reaction to the Fed is much more dependent on the "how much," "how far" and "how fast" than on "the when." On the "how much" and "how far," the Fed's latest "dot plots" (a new set of dot plots will be released this week) put the endpoint of the Fed funds rate at 3.75%. The fed funds futures contract for mid-2018 puts the Fed funds rate at just 1.75%. This gap has widened since the last time the dot plots were released in June 2015. There is also disagreement on the "how fast." The Fed's dot plots published in June 2015 put the Fed funds rate at 1.625% by the end of 2016, implying that the Fed would raise rates by 150 basis points (1.5%) over the course of late 2015 and early 2016. The Fed funds futures market puts the Fed funds at just 0.80% by the end of 2016, suggesting less than 75 basis points (0.75%) of hikes over the next 15 months.

How--pun intended--the gap between the market's view of the Fed and the Fed's view of its own policy closes remains crucial to market (and economic) behavior over the next several years. If, as has been the case over the first five FOMC meetings of the year, the Fed lowers its view of the economy, inflation, the dot plots, etc. and pushes out the timing of the first Fed hike, risk assets (equities, high-yield bonds, etc.) may benefit. The opposite is likely to occur if the market--perhaps driven by a sudden, unanticipated uptick in inflation, wages, economic activity, or oil prices--has to move up its view of "how much," "how far," and "how fast" in a short period. The data received to date, along with the international backdrop and the recent tightening of financial conditions, continue to suggest the Fed will come back to the market at this week's meeting, although it remains committed to achieving "the when" by the end of this year.

CLARITY NEEDED

Markets have been focused on when the first rate hike will be, and because the Fed has not started a rate hike cycle in 11 years, the "when" is certainly important. The current disconnect on the "how much" and "how fast" between the FOMC and the financial markets--and how it ultimately gets resolved--could be a major issue for financial market participants in the months ahead. We'll be watching it closely.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for your clients. Any economic *forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.*

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.
Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

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Weekly Market Commentary | Week of September 14, 2015

KEY TAKEAWAYS

- Fighting the Fed may be a winnable battle for EM.
- EM valuations are compelling and, in our view, have priced in a fair amount of risk.
- We see sufficient upside potential to maintain modest EM equity allocations despite significant growth challenges.

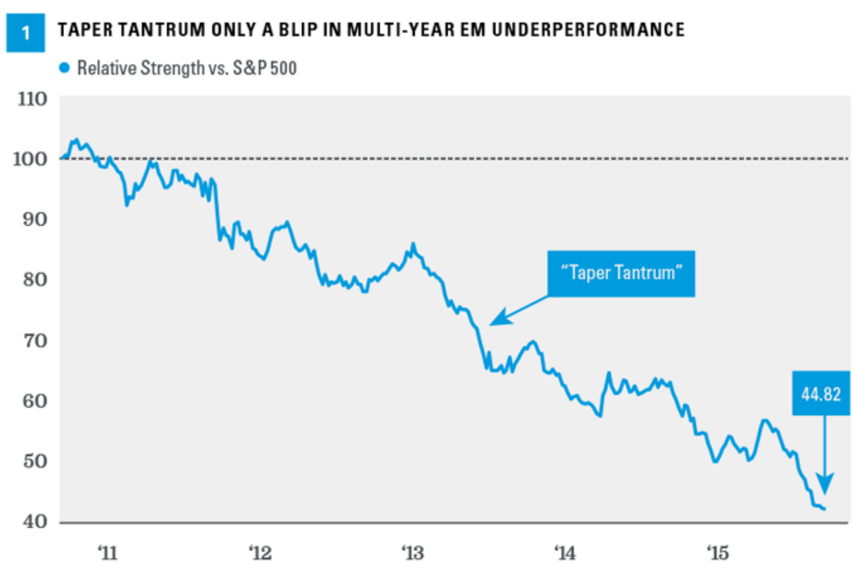
SHOULD EMERGING MARKET INVESTORS FIGHT THE FED?

Emerging market stocks have not won much lately, but the Fed may be a winnable fight. The Federal Reserve, which announces its policy decision on September 17, 2015, is on the verge of starting a rate hike cycle for the first time in more than 10 years. We have previously written that the start of Fed rate hikes has not marked an impending end to bull markets for U.S. stocks (despite the popular Wall Street adage "don't fight the Fed.") In reality, the first rate hike has told us we are about halfway through the cycle as discussed in our *Weekly Market Commentary* of August 25, 2014.

But what about emerging markets (EM)? Aren't these markets more dependent on low interest rates and stimulative monetary policy? Here we look at how EM has performed leading up to and after the start of prior Fed rate hike campaigns. While historical data are limited, we believe this exercise may steer EM investors to consider "fighting the Fed."

WALK DOWN MEMORY LANE

Before we take a walk down memory lane to assess how emerging markets equities might handle Fed rate hikes, some context is important. EM has performed poorly for five years now, having underperformed the S&P 500 by more than 50 percentage points during that period [Figure 1]. Tighter expected monetary policy is among the factors that contributed to this weakness. But we would argue that EM's struggles go much deeper than that and can mostly be explained by other factors as we discuss below.



Source: LPL Research, FactSet 09/11/15

Indexes are unmanaged and cannot be invested in directly.

It is evident from looking back at performance during the "Taper Tantrum" during May through July 2013 (annotated in Figure 1) that Fed fears contributed to EM weakness. In May 2013, the Fed announced it would taper bond purchases associated with its quantitative easing program, which caused rate hike fears to intensify sending the 10-year Treasury yield more than 100 basis points (1%) higher in only about eight weeks. This period, during which EM underperformed the S&P 500 by about 12 percentage points, provided a reminder that EM had become somewhat dependent on low interest rates associated with quantitative easing. But as the figure shows, this was just a blip within a prolonged and much more significant period of weakness.

International and emerging markets investing involves special risks, such as currency fluctuation and *political instability, and may not be suitable for all investors.*

So should investors sell EM because of the Taper Tantrum? Not necessarily. We have two Fed rate hike cycles to assess (1990s and 2000s) for a more complete picture and EM generally performed well around both of them as shown in Figure 2. (Note that the MSCI Emerging Markets Index only goes back to the late 1980s.)

February 1994. The Fed rate hike in February of 1994 (on February 4, 1994) was proceeded by a roughly 70% rally in EM over the prior 12 months (all performance data in U.S. dollars), compared to just a 4% gain in the S&P 500 during that period despite the U.S. being in the early part of its economic cycle. Chinese economic growth was at its peak (gross domestic product increased at a 14-15% annual pace in 1994) and EM investing was beginning to gain popularity with U.S. investors.

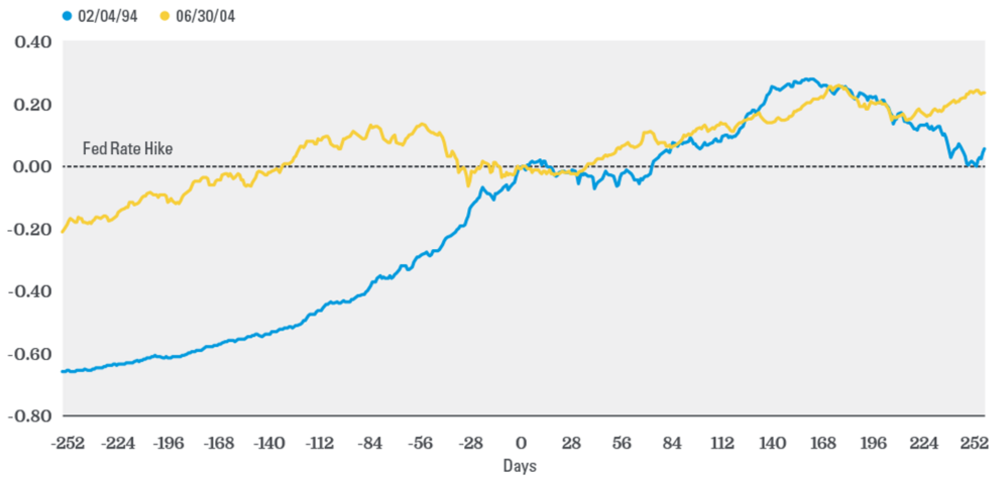
In contrast, EM sold off after the February 2004 rate hike, suffered an 18% correction between September 19, 1994 and the one-year anniversary of the rate hike on February 4, 1995. During this period the S&P 500 actually managed a 1.6% gain. The EM selloff actually went quite a bit further, eventually becoming a 27% bear market decline by early March 1995. Even those EM losses only erased less than half the gains during the 12 months before the rate hike. It is also worth noting that this EM selloff failed to slow the U.S. market down as the S&P 500 went on to post a 34% gain in 1995.

Before worrying about a repeat of that EM decline in 1994 after a potential rate hike this fall, we would argue that the Fed had little to do with the EM losses in 1994. Late 1994 was the start of the Mexican peso crisis that brought a 50% currency devaluation (far from the mere 3% devaluation of the Chinese yuan a few weeks ago).

Also consider that EM just endured a bear market decline of 25% from May 1, 2015 to September 4, 2015, so the market has likely priced in a fair amount of interest rate (and currency) risk.

2 EM STOCKS PERFORMED WELL AROUND START OF 1994 AND 2004 FED RATE HIKE CYCLES

Emerging Markets Performance Around Fed Rate Hike



Source: LPL Research, FactSet 09/11/15

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Past performance is not indicative of future results.

June 2004. EM performed very well in the 12 months ahead of the start of the Fed rate hike campaign that began on June 2004, with a 23% advance. While that trailed the pre-rate hike EM performance in 1993-1994, EM performed better one year after the hike in 2004 than in 1994, posting a 23% gain from June 30, 2004 through June 30, 2005. That performance outpaced the S&P 500, which gained 17% during the 12 months before the hike and just 5% during the 12 months after. China's economy was still growing very rapidly during this period (about 10% GDP growth) and the China-fueled commodities boom was well underway and helped attract capital into emerging markets.

Although this generally good EM performance during these periods came with some volatility, and in the case of 1994 preceded a Mexican currency crisis, it should provide at least some comfort for those with EM positions who may be worried about the Fed. That said, the EM environment is quite different today.

SLOWER GROWTH

China is no longer growing at the double-digit rates of the 1990s and 2000s. Its growth rate is likely closer to 5-6% today (though they continue to report 7%). Because of China's key role as a growth engine for EM, matching the strong performances of 1994 and 2004 may be difficult. Growth is also slower in the U.S. and Europe than it was then, limiting EM export opportunities.

COMMODITY BEAR

We are also in a severe commodity bear market today. Based on the Bloomberg Commodity Index, commodity prices have fallen 63% from their July 2008 peak. Many of the largest EM countries that rely on commodity exports, such as Brazil and Russia, have been hurt by the significant commodity price declines in recent years. The absence of commodity price gains, due largely to less demand from China as it transitions to a more consumer-oriented economy, is a big difference between the EM environment today and that of 1994 and, especially, 2004. Broadly, the benefits that lower oil prices have brought to EM commodity importers have not been enough to offset the drag on EM commodity producers.

BUT THERE ARE POSITIVES

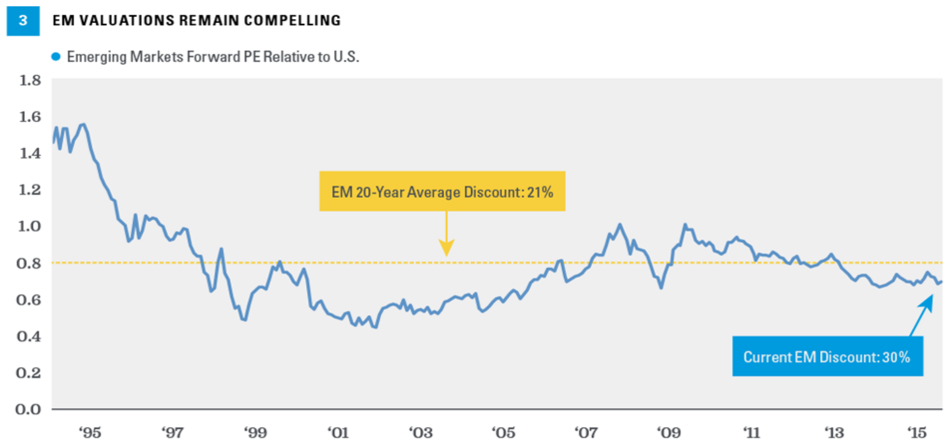
While these key differences suggest more modest returns ahead from EM, we would also highlight several factors suggesting EM is better equipped to manage the risk of impending Fed rate hikes. First, more countries have floating currencies (rather than U.S. dollar pegs) with bigger foreign currency reserves, and are therefore less susceptible to currency crisis. Second, current account balances have improved, reducing reliance for many EM countries on foreign capital (capital that would be more expensive at higher interest rates) and keeping external debt levels manageable. And third, budget deficits are well contained (only a small handful including India and South Africa are worse than the U.S.). There are a few trouble spots, but EM countries in aggregate are generally in good financial shape.

UPDATED EM VIEW

EM is facing a lot of challenges. In addition to slowing economic growth and the risks surrounding tighter monetary policy, the asset class faces other headwinds:

- **Earnings declines.** Earnings are falling about 20% year over year, far worse than flat performance in the U.S. (and there are certainly headwinds we are facing here at home). Slower economic growth and commodities weakness are a big reason for this, but until EM can deliver some earnings stability and market participants see brighter days ahead, it will be difficult for these markets to get much going.
- **Technical weakness.** The MSCI Emerging Markets Index is exhibiting downward momentum based on the index price being below the downward sloping 50- and 200-day simple moving averages. Our assessment of the EM index chart, without consideration for fundamentals or valuation, tells us to wait for a better entry point.
- **Geopolitics and governance.** This headwind has always been there and is largely reflected in valuations, in our view, but is worth highlighting. There are conflict of interests between the corporate sector and the public sector, and poor accounting transparency (China, for example). There is political instability, such as we have seen in Greece in recent years. Corporate scandals are more prevalent, with Brazil's largest energy company a recent example. And we all know about the risks of military conflict, e.g., Russia, and terrorism in the Middle East and beyond.

Bad place to invest, right? Not necessarily. We believe valuations are compelling enough that a modest allocation to EM equities as a diversifier to a predominantly U.S.-centric equity portfolio still makes sense. EM is now trading at about a 30% discount to the U.S. based on the forward price-to-earnings ratios of the MSCI EM Index and the S&P 500 [Figure 3]. We would also note that we expect China economic growth and therefore commodities prices to stabilize over the next 3-6 months, which should help buoy EM sentiment. While governance is still not up to developed market standards, market friendly reforms have been implemented in some markets such as India and Mexico, and even China. Finally, although the technicals tell us EM is in a clear downtrend, this discipline also tells us that when EM turns around, there may potentially be an attractive upside opportunity if the index can retrace some of its latest decline.



Source: LPL Research, FactSet, Thomson 09/11/15

Past performance is not indicative of future results.

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

CONCLUSION

Fighting the Fed may be a winnable battle for EM. A lot of rate hike risk has been priced in following significant recent underperformance. EM performed quite well during prior Fed rate hike cycles in the 1990s and 2000s, while most of EM is better positioned financially to weather rate hikes than in the past. Valuations are compelling and, in our view, have priced in a fair amount of risk and earnings weakness. Growth challenges are significant, but we see sufficient upside potential to maintain modest EM equity allocations.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

A simple moving average is calculated by adding the closing price of the security for a number of time periods and then dividing this total by the number of time periods. Short-term averages respond quickly to changes in the price of the underlying, while long-term averages are slow to react.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, disease, and regulatory developments.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The Bloomberg Commodity Index is calculated on an excess return basis and composed of futures contracts on 22 physical commodities. It reflects the return of underlying commodity futures price movements.

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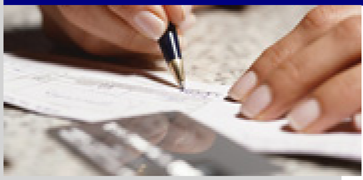


Should You "Fix" Variable Rate Debt?

Individuals may be evaluating the potential benefits of converting variable-rate loans, including adjustable rate mortgages (ARMs), home equity lines of credit, and student loans, to a fixed rate.

While investors are keeping a close watch on the Federal Reserve for indications of when it will start raising interest rates, the consensus among economists is that it will begin its credit-tightening cycle at some point this year.

Of course there are two sides to the interest rate coin: the investor and the borrower. Rising rates are generally good news for savers and investors, but they represent an expense for borrowers and increase the cost of taking out loans and mortgages.

In the current environment, individuals may be evaluating the potential benefits of converting variable-rate loans, including adjustable rate mortgages (ARMs), home equity lines of credit, and student loans, to a fixed rate.

Only One Way to Go

Interest rates are still at historic lows and are only likely to go up from here. Personal finance experts typically favor refinancing, when practical, to a fixed rate for the stability it provides the borrower. With a fixed-rate loan the borrower will not have to be concerned if there is a sudden spike in interest rates. What's more, individuals with fixed-rate debt have much more control over their budget and can plan ahead with more confidence, as they have a clear, predictable picture of their monthly income and expenses.

While adjustable-rate loans may have lower initial interest rates than fixed-rate loans, the lower interest rate is only for a set period of time. At the end of the fixed period, the monthly loan amount "adjusts" based on the market rate or index. In this case, refinancing may be a smart choice if your ARM is adjusting to an interest rate that is higher than the current market rate.

How Low Are Rates?

Just how low are short-term rates now, historically speaking? Most lenders base their variable rates off a LIBOR rate, which stands for London Interbank Offered Rate and works as a benchmark rate for banks internationally.[1] As the LIBOR changes, so does the variable rate. The LIBOR is low today, compared to its 10-year and 20-year averages (see table below), but once it begins to increase, borrowers holding adjustable rate loans will see an increase in their regular payments. While most variable rate loans will have an upper interest rate cap, it is important to know what that maximum rate is -- and whether you could handle that potential debt load -- before signing any documents.

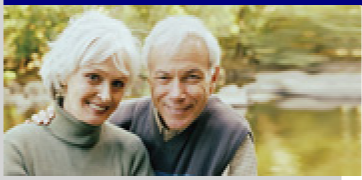
LIBOR -- Then and Now

	10-year average	20-year average	July 6, 2015
6-month LIBOR	1.95%	3.09%	0.44%
12-month LIBOR	2.17%	3.29%	0.76%

Source: Federal Reserve Economic Data (FRED). For the dates indicated. The 10-year and 20-year averages are for the period ended July 6, 2015.

Generally, a variable rate loan is a safe bet for individuals who plan to repay their loan quickly. And while the Federal Reserve is expected to begin raising rates soon, it is likely to take a very measured, slow path.

[1]*Source: U.S. News.com, "Fixed or Variable: Which Interest Rate Should You Choose?" July 14, 2015.*



Intra-Family Money Transfers Almost Always Go to the Young

When the tables were reversed, younger family members were shown to be far less likely to give money to older relatives -- and when they did give, they gave far less.

A new study by the nonpartisan Employee Benefit Research Institute (EBRI) found that when money is being transferred among families, it almost always flows away from older households to younger generations.[1] In addition, the research found a distinct correlation between income levels and amounts of money being transferred as well as the occurrence of such transfers.

Specifically, from 1998 through 2010, it was reported that 38% to 45% of older households (defined as those where at least one member of the household was age 50 or above) had made transfers to their children or grandchildren in the past two years. By comparison, just 4% to 5% of older households reported *receiving cash* from their younger family members during the same time span.

(For the purposes of this study, *transfers* are defined as "giving money, helping pay bills, or covering specific types of costs such as those for medical care or insurance, schooling, down payment for a home, rent, etc. The financial help can be considered support, a gift, or a loan.")

While parents and grandparents are offering financial assistance to younger family members, the amount they transfer declines significantly with their age. For instance, the data showed that between 2008 and 2010, the amount transferred by households with at least one member between the ages of 50 and 64 averaged $8,350, while households with members aged 85 or above gave about half that amount: $4,787.

When the tables were reversed, younger family members were shown to be far less likely to give money to older relatives -- and when they did give, they gave far less. The study showed that during the same two-year period, the oldest households -- those with at least one member age 85 or above -- received the highest average transfer of all age groups, which was just $359.

Not surprisingly, it was revealed that households in the top income quartile transfer much larger amounts to family members than those in the lower quartiles. In 2010 for example, transfers among households in the top income quartile with at least one member between the ages of 50 and 64 topped $27,000, while those in the bottom three quartiles of the same age group gave away $7,419, $7,411, and $13,616, respectively in 2010. Still everything is relative, and for lower income households, these amounts are significant and, researchers contend, could jeopardize their financial future.

Commenting on the findings, EBRI research associate and author of this study, Sudipto Banerjee said, "For older households, cash transfers can reduce their retirement assets, raising concerns about retirement security, particularly for low-income groups."[2]

For more on this study or to learn more about EBRI, visit its website.

[1] *Employee Benefit Research Institute, Issue Brief, No. 415, "Intra-Family Cash Transfers in Older American Households," June 2015.*

[2] *Employee Benefit Research Institute*, press release, "Despite an Aging Population, Most Family Money Transfers Flow to the Young," June 18, 2015.

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