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Rates will likely rise

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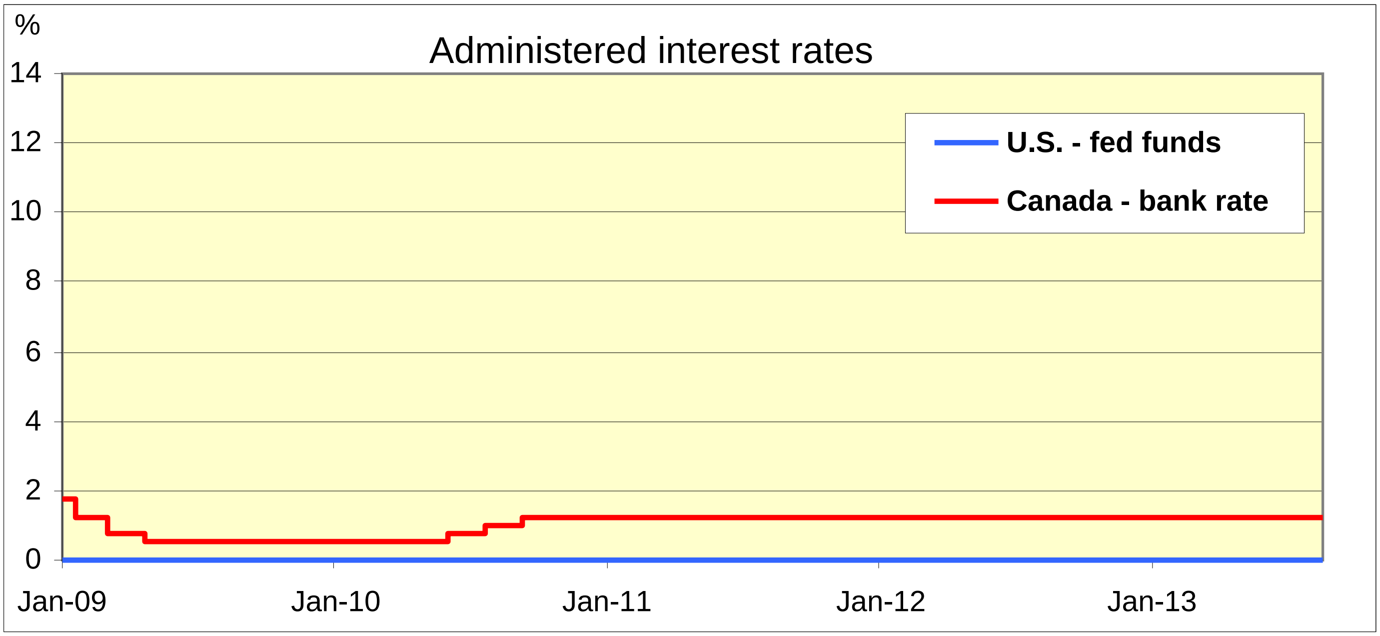
Following the regularly scheduled meeting of the U.S. Federal Reserve Board's Open Market Committee (FOMC) on June 18 and 19, global equity markets experienced heavy selling pressure. The S&P 500 Index declined 4.8% over a four-day period, its worst such stretch in 20 months. At home, the S&P/TSX Composite Index recorded a similar 4.3% drop over the same period. Interestingly, it wasn't a change in policy that prompted the move down. The press release that accompanied the usual announcement hinted that the Fed would begin to taper its program of quantitative easing (QE), as economic circumstances warranted. Subsequently, stronger economic numbers were not viewed as positive news for the market. Perversely, the markets acted as if an economy where there was no need for stimulus was somehow a negative development. Pundits described this as a sign that the markets were "addicted" to the stimulus. Eventually, calming words from Fed Chairman Ben Bernanke allowed the markets to recover, and move higher. Nevertheless, the market reaction underscores investor trepidation with respect to any thought that the Fed specifically, and central banks generally, will alter their current "easy money" policies. However, a return to more "normal" interest rate, economic and market environments should not be viewed negatively. Rather than burying their heads in the sand, investors are better served by confronting the reality that monetary policy will eventually change, prepare for it, and perhaps even take advantage of it.

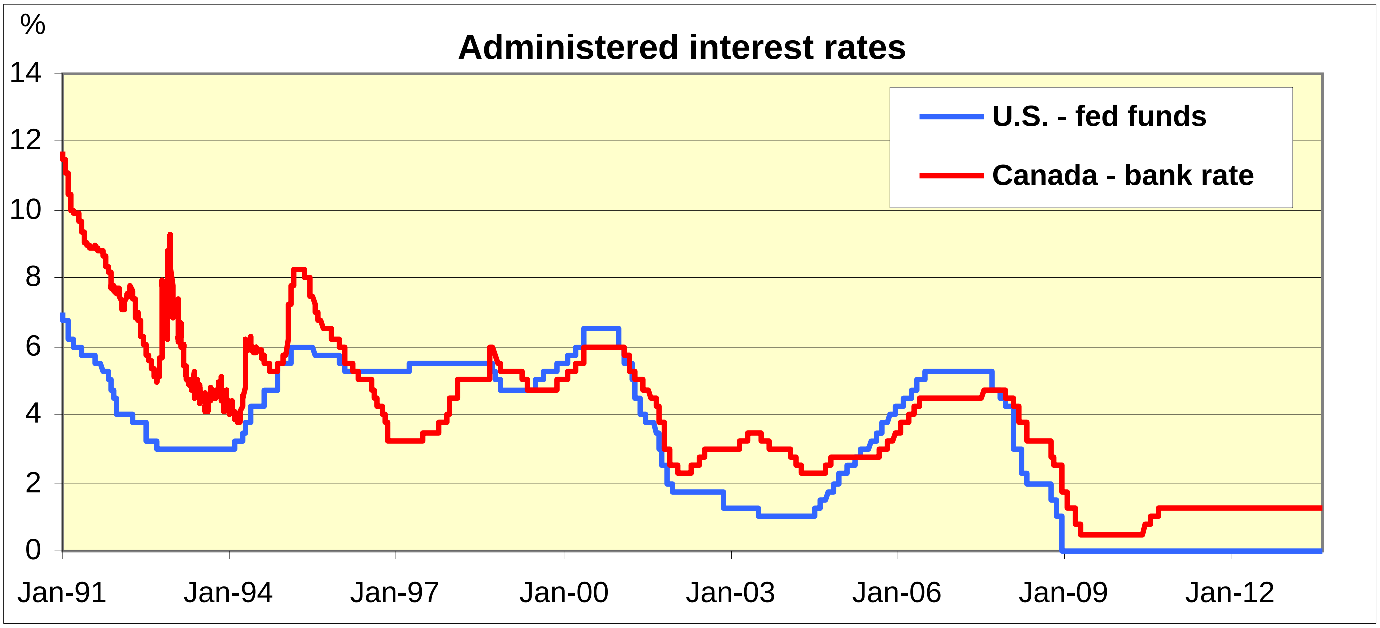
Quiet backdrop



Source: U.S. Federal Reserve Board, Bank of Canada

It is easy for market participants to become accustomed to a particular, stable element of the investment environment. As can be seen in the graph on the previous page, administered interest rates have been unchanged in Canada since September 8, 2010. In the U.S. they have been flat since December 16, 2008. In the wake of the market meltdown of 2008-2009, central banks around the world collaborated to deliver a clear message that they were united in their efforts to avoid liquidity problems that could result in a seizing of financial transactions. Since then, global economic growth has been relatively soft. A combination of government austerity and easy monetary policy has been the norm in virtually every region. Low interest rates have formed a stable backdrop for the markets.

However, economic growth rates are beginning to vary across the globe and the need for fully unified policies is diminishing. In China, GDP growth has slowed, albeit to a 7.5% annual rate that is the envy of the rest of the industrialized world. In Japan, political change and new leadership at the Bank of Japan suggest that its moribund economy may begin to see some renewal. In Europe, the debt crises of Portugal, Italy, Ireland, Greece and Spain have faded, perhaps temporarily, from the headlines but it appears that these nations' balance sheets are beginning to improve. In North America, U.S. GDP came in with a 1.7% (annualized) second quarter growth rate despite a heavier tax burden and continued cuts in government spending. Domestically, GDP growth stood at 2.5% (annualized) during the first quarter. As more time passes, policies tailored to specific needs of each country or region can be expected to take precedence once more.



Source: U.S. Federal Reserve Board, Bank of Canada

It may take time for investors to become re-acquainted with the notion that interest rates can actually rise and fall. As can be seen in the graph above, the periods preceding the 2008-2009 sell-off show rate cuts and hikes designed to either stimulate the underlying economy or combat inflationary pressures. Easing and tightening cycles have always been expected as more normal economic conditions return.

U.S. Tightening cycles

FED TIGHTENING CYCLES Greenspan / Bernanke Period								
Date of First Rate Hike Cycle Begins	Date of First Rate Cut Cycle Ends	Number of Months in Cycle	Fed Funds at LOW %	Fed Funds at HIGH %	Total Hike Basis pts	Fed Funds Percentage Change in Rate	Number of Hikes	Average Hike Basis pts
4-Sep-87	19-Dec-90	40	6.10	9.85	375	61.5%	3	125
4-Feb-94	6-Jul-95	17	3.00	6.00	300	100.0%	7	43
25-Mar-97	29-Sep-98	18	5.25	5.50	25	4.8%	1	25
30-Jun-99	3-Jan-01	18	4.75	6.50	175	36.8%	6	29
30-Jun-04	17-Aug-07	38	1.00	5.25	425	425.0%	17	25

Source: U.S. Federal Reserve Board

Interestingly, a number of articles[1] have compared the pending tapering of QE and eventual interest rate increases to the tightening cycle of 1994. As the table above shows, there were five tightening cycles in the Greenspan/Bernanke era. In looking at the numbers, however, nothing in particular stands out with respect to the tightening cycle that began in February 1994. Still, the market reaction to that cycle does stand out. The bond market definitely responded as the interest rates on two-year Treasury Notes rose from 4.10% to 6.25%. Similarly, 10-year Treasury Notes saw interest rates rise from 5.70% to 7.25% and interest rates on 30-year Treasury Bonds went from 6.25% to 8.00%. The bond market did not move in isolation as stocks were also affected. After closing at what was then an all-time high of 482.0 on February 2, 1994, the S&P 500 Index fell 8.9% by April 4 of that year. A full recovery would not arrive until February 14, 1995. All of this came against a backdrop of relatively neutral inflation, which remained between 2.5% and 3.0%, and a slowly improving unemployment rate (6.6% to 5.6%).

While the Bank of Canada is often accused of simply following the Fed, that was not the case this time. As can be seen in the following table, Canada's central bank delayed its first rate hike until November 1994, a full nine months and six Fed moves later. Regardless of the timing, the market response was similar and in some ways even stronger. Government of Canada two-year bonds saw interest rates virtually double from 4.25% to 8.35%. Interest rates on Government of Canada 10-year bonds climbed from 6.35% to 9.35%. Meanwhile, the rates on Government of Canada 30-year bonds increased from 7.00% to 9.45%. Similarly, the Canadian equity market eventually experienced an even bigger sell-off than what was seen south of the

[1] The '1994 Moment' Is Keeping More And More Bond Traders Awake At Night. , ***Business Insider*** January, 2013; Can the Fed avoid a repeat of 1994's bond market carnage? , ***Financial Post*** March, 2013

border. The S&P/TSX Composite Index waited until March 23, 1994 to close at a then all-time-high of 4,609.9. The subsequent sell-off took the market down 14.1% by June 24, 1994. A full recovery in the Canadian equity market emerged on July 7, 1995.

BANK OF CANADA TIGHTENING CYCLES

Date of First Rate Hike Cycle Begins	Date of First Rate Cut Cycle Ends	Number of Months in Cycle	Bank Rate at LOW %	Bank Rate at HIGH %	Total Hike Basis pts	Bank Rate Percentage Change in Rate	Number of Hikes	Average Hike Basis pts
3-Nov-87	29-May-90	31	8.09	14.05	596	73.7%	17	35
16-Nov-94	8-May-95	6	5.25	8.25	300	57.1%	7	43
26-Jun-97	29-Sep-98	15	3.25	6.00	275	84.6%	6	46
17-Nov-99	23-Jan-01	14	4.75	6.00	125	26.3%	4	31
16-Apr-02	15-Jul-03	15	2.25	3.50	125	55.6%	5	25
8-Sep-04	4-Dec-07	39	2.25	4.75	250	111.1%	10	25
1-Jun-10	15-Aug-13*	39	0.50	1.25	75	150.0%	3	25

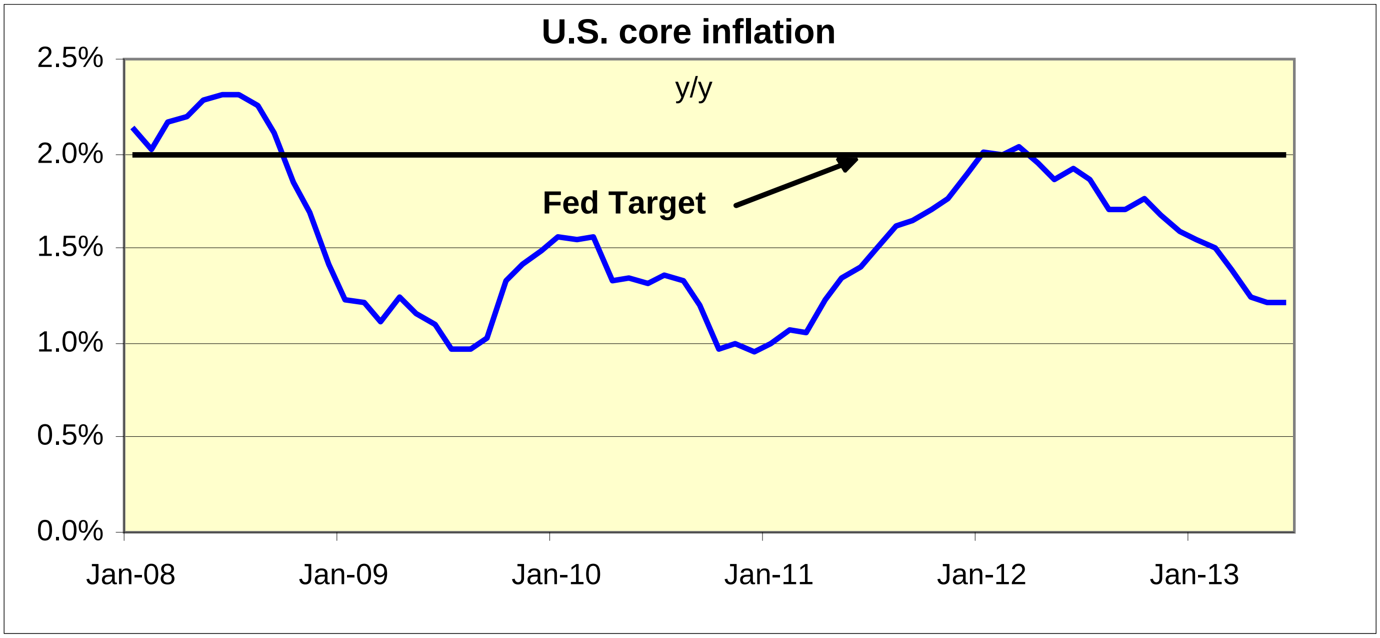
*Represents developments in the cycle at the time of print
Source: Bank of Canada

This is not 1994

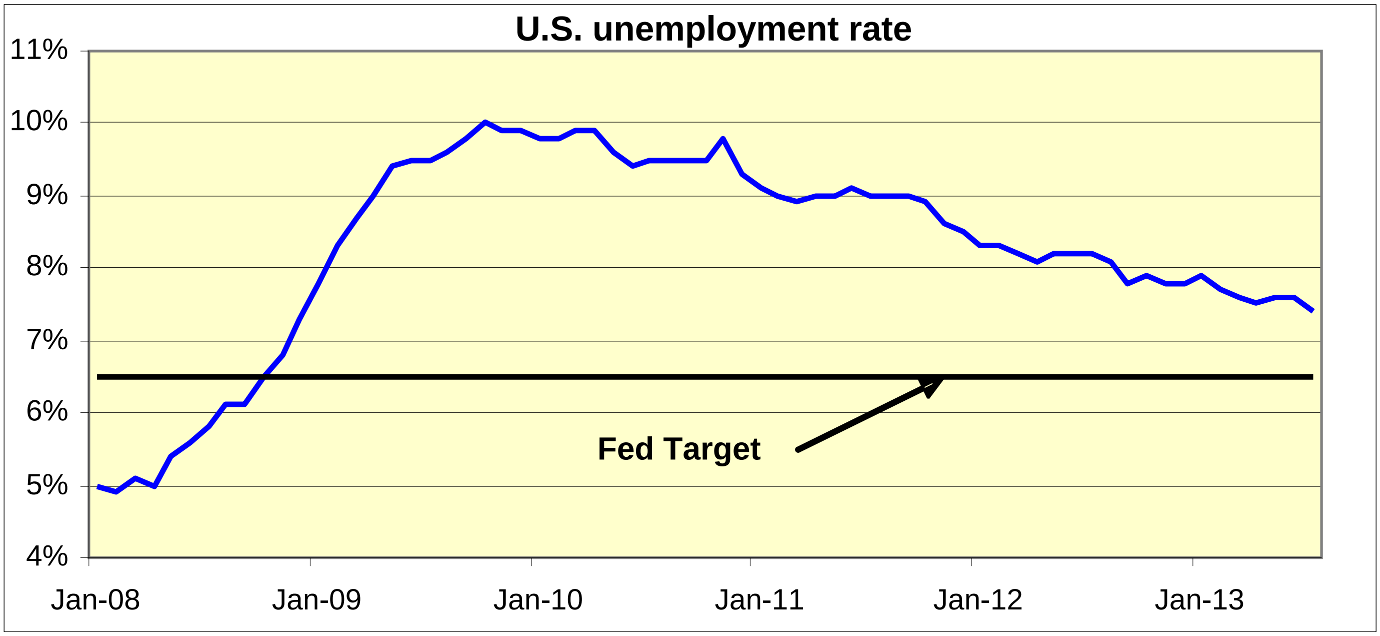
While some may see similarities between 1994 and the present market environment, a number of things are different. Chief among them is the way in which the Fed conducts monetary policy. Those market veterans with long memories will recall that the U.S. central bank had a strong preference for obfuscation in the past. The Fed genuinely preferred to keep the market guessing and Chairman Alan Greenspan was known for his ability to say nothing at all in as many words as possible. Perhaps his most famous quote sums it up nicely: "I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said." This is a far cry from the Fed's current preference for providing clarity to legislators and the market.

It is not just the communication that was different. The first tightening of the 1994 cycle in the U.S. was expected. It occurred on February 4 on the day of the FOMC meeting. One of the tightening moves in 1994 took place without a meeting and the second-to-last tightening move of the cycle was a substantial 75 basis point hike (a basis point is 1/100th of one percentage point). That hike took place on November 15, 1994 and since then, there has not been one of that size. Since those days, market participants have been conditioned to expect policy announcements in a narrow window between 2:10 p.m. and 2:20 p.m. and only after the FOMC meets.

One of the other things that has changed is the Fed's adoption of an inflation target. As seen in the graph below, U.S. core inflation has been below this target for most of the past five years.

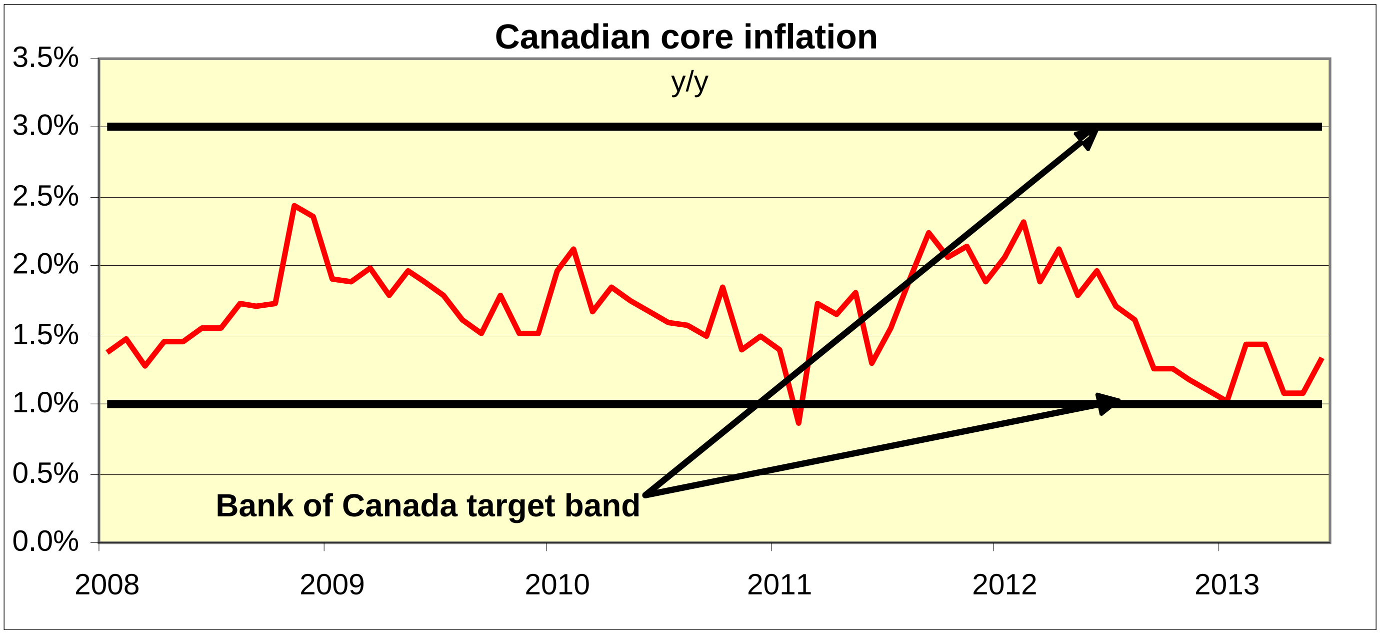


Source: U.S. Bureau of Economic Analysis



Source: U.S. Bureau of Labor Statistics

In addition to the inflation target, the Fed has adopted an unemployment rate target. Again as seen in the graph above, it is not surprising that the unemployment rate has exceeded the target rate since mid-2008. Using highly visible statistics as a monetary policy tool makes it easier for market participants to anticipate changes.



Source: Statistics Canada

The Bank of Canada adopted an inflation "target band" in 1991. As seen above, it has been well contained over the past five years, albeit with some brief tests of the lower boundary. At present, there is no real evidence that Canada's economy or that of the United States is facing anything remotely resembling a capacity constraint. Unemployment rates remain well above pre-recession levels and inflationary pressure shows few signs of re-emerging. Undoubtedly, it will take continued, material economic gains to warrant higher interest rates on these bases. As this occurs, financial markets will respond by re-pricing both debt and equity instruments based on expectations for the scope of the policy changes. These changes are likely to take place against a backdrop of increased volatility, as has already been witnessed. Similarly, it appears likely that the next tightening cycle, when it does appear, will be well telegraphed by the central banks. Equally, raising interest rates will very likely be a slow and cautious process when it does occur.

Conclusions

- After years of unified, highly stimulative monetary policy, most regions appear poised to adopt changes that suit local conditions. In North America, quantitative easing will be wound down and interest rates will eventually rise in both the U.S. and Canada.
- Market fears of a repeat of the 1994 tightening cycle will likely result in elevated volatility. However, the central banks are far more communicative and clear in their approach than was the case 20 years ago.
- A return to more typical business cycles is a positive development given the recent history of uncertain economic and market environments. Investors who take advantage of professional investment advice can help ensure a smoother transition as these events unfold.