Weekly Trends

PRIVATE CLIENT SOLUTIONS

Ryan Lewenza, CFA, CMT, Private Client Strategist

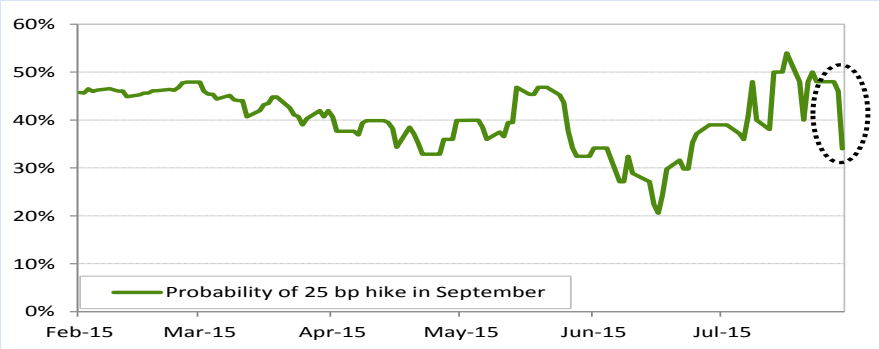
August 21, 2015

The Case For/Against A Fed Rate Hike

- With less than a month to go before the next Federal Open Market Committee (FOMC) meeting, capital market participants are fixated on whether the Fed will hike rates for the first time since 2006 at the September 16-17 meeting.
- The case against the Fed hiking rates is centered on the belief that the US economy is still too weak to justify raising rates. This camp points to the below-trend US economic growth, the strong US dollar, low oil prices, and the weakness abroad, notably from China.
- The other camp points to the robust US job growth which satisfies one the Fed's two key mandates. For example, the US economy has created 2.9 mln jobs over the last 12 months, which is above the average job growth of 2.4 mln before previous Fed tightening cycles.
- While we acknowledge that the US economy is running at half-speed, and that inflation is benign, we believe the strength in the labour market is sufficient to justify the Fed hiking rates in September.
- The investment implications of an inevitable Fed rate hike are: 1) stocks typically sell off shortly following the first Fed rate hike but then recover, with the S&P 500 gaining on average 5% in the year after the first Fed hike; 2) Canadian energy, industrials, heath care and telecom services sectors typically outperform following Fed hike (we prefer the industrials and telecom services); 3) the CAD dollar and bonds underperform; and 4) commodities have typically done well, but we remain cautious.

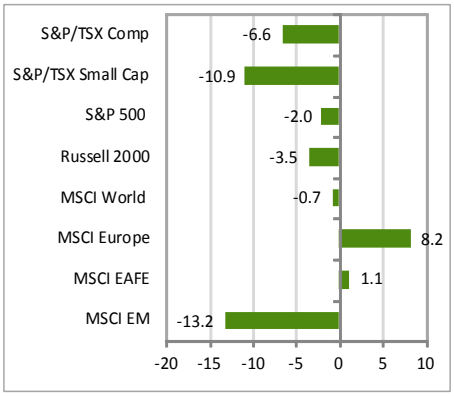
Chart of the Week

Futures Are Pricing In A 34% Probability Of A September Fed Hike, Down From 48% On August 18, Just Before The July Fed Minutes Release



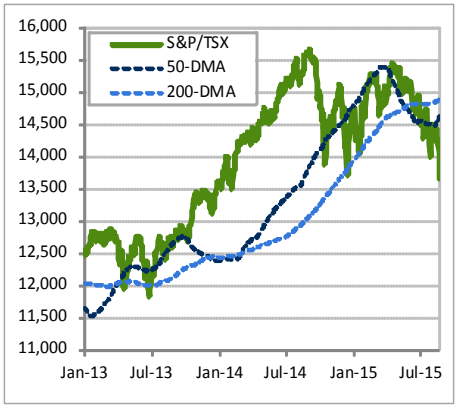
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	TSX Weight	Recommendation
Consumer Discretionary	7.0	Overweight
Consumer Staples	4.3	Market weight
Energy	18.4	Market weight
Financials	35.7	Market weight
Health Care	5.8	Market weight
Industrials	8.1	Overweight
Information Technology	2.8	Overweight
Materials	10.2	Underweight
Telecom	5.4	Market weight
Utilities	2.2	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	13,668.3	
50-DMA	14,495.6	Downtrend
200-DMA	14,781.4	Downtrend
RSI (14-day)	28.0	Oversold



Source: Bloomberg, Raymond James Ltd.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

RAYMOND JAMES

The Case For/Against A Fed Rate Hike

With less than a month to go before the next FOMC meeting, capital market participants are fixated on whether the Fed will hike rates for the first time since 2006 at the September 16-17 meeting. In this week's publication we discuss the case for/against a Fed rate hike in the coming months, and outline the investment implications of a Fed rate hike.

The case against the Fed hiking rates is centered on the belief that the US economy is still too weak to justify raising rates. This camp points to the below-trend US economic growth, the strong US dollar which is impacting exports and corporate profits, weak oil prices which is weighing on the energy sector, and the weakness abroad, notably from China. While we're in the camp that believes the Fed should hike interest rates, it's difficult to dispute these points. In trying to determine whether the Fed will hike rates we compiled a list of key economic and market indicators that the Fed is likely considering in helping them make the decision. Specifically, we looked at employment data, inflation and one year stock market returns at the start of each Fed tightening cycle since 1970. The camp against a Fed rate hike stress that inflation is still well below the Fed's 2% target (headline CPI at 0.1% Y/Y and PCE Core at 1.3%), which in their view, provides the Fed with ample time to keep rates low. They also note that the US participation rate is low, which is a sign that the US labour market is not nearly as strong as some posit.

The other camp points to the robust US job growth which satisfies one the Fed's two key mandates. For example, the US economy has created 2.9 mln jobs over the last 12 months, which is above the average job growth of 2.4 mln before previous Fed tightening cycles. As a result of the strong job growth, the unemployment rate has declined to 5.3%, which is close to "full employment" and below the average 5.9%. Finally, we believe the Fed closely monitors US equity market performance in assessing the economy's strength, and we note that the S&P 500 is up 9% Y/Y, which is in line with the average gain prior to previous Fed tightening cycles.

While we acknowledge that the US economy is running at half-speed, and that inflation is benign, we believe the strength in the labour market, in addition to other parts of the economy, is strong enough to justify the Fed hiking rates in September. Yes, the economy is not great, but when is it ever an ideal time to raise rates? Moreover, lowering rates to zero was an emergency measure to help resuscitate the US economy. While the US economy is still recovering, it is no longer on its death bed, and therefore no longer requires the emergency zero interest rate policy.

Factors In Fed Rate Decision

Rate Hike Date	Unemployment Rate (%)	12 Mth Cumulative Job Growth ('000)	US Participation Rate (%)	CPI Y/Y (%)	PCE Core Y/Y (%)	US Wages Y/Y (%)	S&P 500 Y/Y Chg (%)
4-Jan-73	4.9	3,176	60.0	3.6	2.7	6.1	11.6%
15-Aug-77	7.0	3,370	62.3	6.6	6.6	7.0	-6.0%
2-May-83	7.5	-464	63.7	3.5	5.1	4.3	45.1%
29-Mar-88	5.7	3,323	65.7	3.9	4.0	2.6	-11.2%
4-Feb-94	6.6	2,736	66.6	2.5	2.3	2.8	5.4%
30-Jun-99	4.3	3,012	67.1	2.0	1.4	3.7	21.1%
30-Jun-04	5.6	1,587	66.1	3.3	2.0	2.0	17.1%
Current	5.3	2,915	62.6	0.1	1.3	1.8	9.0%
Average	**5.9**	**2,457**	**64.3**	**3.2**	**3.2**	**3.8**	**11.5%**
Median	**5.7**	**2,964**	**64.7**	**3.4**	**2.5**	**3.3**	**10.3%**
Reading	✓	✓	×	×	×	×	✓

Source: Bloomberg, Raymond James Ltd. ✓ = For; × = Against Fed rate hike

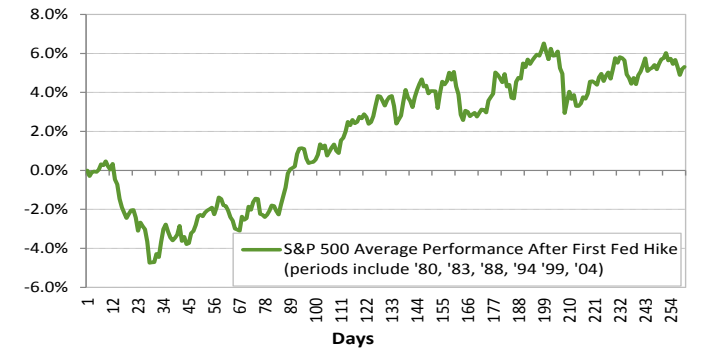
Investment Implications

This week we received the July Fed minutes which signalled that the Fed is close to hiking rates. "Most judged that the conditions for policy firming had not yet been achieved, but they noted that conditions were approaching that point," according to the statement. Whether the Fed hikes in September or December (October is unlikely as there is no press conference) remains to be seen, but when it does happen there will be reverberations felt across the capital markets. These include:

- **Equities**. Typically, stocks sell off shortly following the first Fed rate hike. We analyzed S&P 500 price performance following the start of each Fed tightening cycle since 1980, and found that, on average, the S&P 500 declined 5% over the first month following the Fed rate hike. But, the S&P 500 then recovers, and goes on to gain 5% on average in the year after the first Fed hike. If this holds, then we should expect to see some weakness around the rate hike. However, given how well telegraphed this Fed rate hike has been, it may turn out to be a non-event. Either way, we don't believe the initial Fed rate hikes will derail the bull market.
- **Sector performance**. Similarly, we studied sector performance one year following Fed hikes and found that the Canadian energy, industrials, health care, and telecom services sectors outperformed, while the utilities sector was the largest underperformer. We remain underweight the utilities sector, overweight industrials which we believe we do better in the H2/15, and have turned more constructive on the Canadian telecom sector.
- **CAD/USD**. The CAD dollar has tended to underperform during Fed tightening cycles. While we believe the CAD is due for an oversold bounce, we see the CAD trending even lower, possibly down to the low $0.70s.
- **Bonds**. Not surprisingly, bonds have sold off following Fed tightening cycles, with the GoC 10-year yield rising 7% on average over the next 12 months. This supports are underweight recommendation of bonds in portfolios.
- **Commodities**. Finally, commodities tend to do well following Fed rate hikes, with the Thomson/Reuters CRB Index up 20% on average, 12 months after the start of the Fed tightening cycle. In the short-term we see the potential for an oversold bounce in commodities, but we remain cautious on the commodity complex, so we would lean against these historical findings.

In summary, we expect the Fed to hike rates soon, which could result in some short-term volatility. But we see stocks higher 12 months after the Fed rate hike, so we would use this weakness to add to stocks.

S&P 500 Sells Off Then Rallies 5% Following Fed Hike



Asset/Sector Returns Following Previous Fed Hikes

1 Year % Change Following Fed Hike	4-Feb-94	30-Jun-99	30-Jun-04	Average	Median
S&P/TSX Energy Index	-14.3	25.7	56.0	22.4	25.7
S&P/TSX Materials Index	-5.6	-10.0	6.0	-3.2	-5.6
S&P/TSX Info Tech Index	-7.9	176.3	-31.1	45.8	-7.9
S&P/TSX Cons Discret Index	-9.9	12.0	7.8	3.3	7.8
S&P/TSX Industrials Index	-2.2	30.0	6.8	11.5	6.8
S&P/TSX Health Care Index	14.1	39.7	-26.7	9.0	14.1
S&P/TSX Cons Staples Index	-16.4	10.8	15.3	3.2	10.8
S&P/TSX Utilities Index	-1.9	-26.0	25.8	-0.7	-1.9
S&P/TSX Telecom Services Index	-6.3	83.2	26.7	34.5	26.7
S&P/TSX Financials Index	-8.7	10.0	16.5	5.9	10.0
CAD/USD Dollar	-4.1	-1.2	8.8	1.1	-1.2
GoC 10 Year Yield	37.3	7.0	-22.5	7.3	7.0
TR/CC CRB Commodity Index	12.1	33.9	14.2	20.1	14.2

Source: Bloomberg, Raymond James Ltd.

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: www.raymondjames.ca/researchdisclosures.

This newsletter is prepared by the Private Client Services team (PCS) of Raymond James Ltd. (RJL) for distribution to RJL's retail clients. It is not a product of the Research Department of RJL.

All opinions and recommendations reflect the judgement of the author at this date and are subject to change. The author's recommendations may be based on technical analysis and may or may not take into account information contained in fundamental research reports published by RJL or its affiliates. Information is from sources believed to be reliable but accuracy cannot be guaranteed. It is for informational purposes only. It is not meant to provide legal or tax advice; as each situation is different, individuals should seek advice based on their circumstances. Nor is it an offer to sell or the solicitation of an offer to buy any securities. It is intended for distribution only in those jurisdictions where RJL is registered. RJL, its officers, directors, agents, employees and families may from time to time hold long or short positions in the securities mentioned herein and may engage in transactions contrary to the conclusions in this newsletter. RJL may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this newsletter. Securities offered through Raymond James Ltd., Member-Canadian Investor Protection Fund. Financial planning and insurance offered through Raymond James Financial Planning Ltd., not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The results presented should not and cannot be viewed as an indicator of future performance. Individual results will vary and transaction costs relating to investing in these stocks will affect overall performance.

Information regarding High, Medium, and Low risk securities is available from your Financial Advisor.