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FED POLICY TIGHTENING GAME PLAN

The Federal Reserve (Fed) is beginning a tightening cycle for the first time in over 11 years. Although this may signal that the Fed believes the U.S. economy is ready to stand on its own two feet, likely providing a positive backdrop for stocks, it may also increase volatility. Expected policy divergence among major global central banks should help support global growth while also potentially creating investment opportunities.

YOUR TIGHTENING GAME PLAN

International and domestic investments, large and small company stocks, and stocks and bonds sectors have all exhibited their own routine in response to Fed rate hikes [Figure 1]. In some cases, the same routine to handle Fed rate hikes may serve investors well; but in others, changing times may require new routines.

We have discussed how stock market returns are, on average, positive the year following the start of rate hikes, but focusing on specific areas of the stock market may boost the odds of success. A look back over the last three Fed rate hike campaigns (February 1994–February 1995, June 1999–May 2000, and June 2004–June 2006) reveals patterns across the stock market.

KEY TAKEAWAYS

- International stocks have fared notably better than their domestic counterparts over the last three rate hike cycles.
- Large company stocks have weathered the start of Fed rate hikes better than small and mid cap companies over the 6- and 12-month periods following a rate increase.
- One year after the first rate hike, the technology sector has continued to exhibit strength, as have both the healthcare and energy sectors, while the consumer discretionary sector has underperformed.
- Treasuries have been the most sensitive to Fed rate hikes in the past and the current period is likely to be similar given still expensive valuations. More resilient sectors included emerging markets debt and high-yield bonds.



Please see our [Outlook 2016: Embrace the Routine](#) publication for insights on the economy, stock and bond markets, and investments for the year ahead.

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TOTAL RETURNS OF VARIOUS INDEXES AFTER THE START OF THE LAST THREE RATE HIKE CYCLES

GLOBAL

	6-Month	12-Month	18-Month
U.S. Stocks	2.8%	2.7%	7.4%
International Stocks	12.0%	7.0%	11.8%
Emerging Markets	12.1%	6.2%	10.6%

MARKET CAP

	6-Month	12-Month	18-Month
Large Cap	6.5%	9.9%	9.4%
Mid Cap	5.1%	9.0%	20.8%
Small Cap	4.7%	5.9%	12.9%

EQUITY SECTOR

	6-Month	12-Month	18-Month
Consumer Discretionary	4.0%	-4.4%	-2.7%
Technology	13.7%	18.7%	18.4%
Healthcare	-5.2%	10.0%	21.9%
Consumer Staples	-3.8%	-2.2%	10.6%
Financials	-1.5%	-4.1%	12.6%
Industrials	1.9%	-1.3%	10.1%
Telecom	3.7%	-5.3%	-11.7%
Materials	3.8%	-10.5%	3.9%
Utility	-2.9%	6.8%	20.0%
Energy	3.9%	12.1%	23.5%
S&P 500	3.8%	4.7%	10.7%

BOND SECTOR

	6-Month	12-Month	18-Month
Treasuries	0.0%	3.1%	8.6%
Mortgage-Backed Securities	1.1%	3.6%	9.1%
Investment-Grade Corporates	0.5%	2.5%	7.9%
High-Yield	2.1%	2.7%	5.7%
Municipals	0.1%	2.6%	7.7%
Emerging Markets Debt	2.4%	6.0%	14.5%
International Bonds	6.0%	4.6%	8.9%
Barclays Aggregate	0.5%	3.0%	8.5%

Source: LPL Research, S&P, Barclays, MSCI, Russell, Bloomberg 11/11/15

The performance data presented represents past performance and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

Asset class returns are represented by the indexes defined in the disclosure section.

Domestic and International Stocks

International stocks have fared notably better than their domestic counterparts over the last three rate hike cycles. The U.S. Fed and international central banks appear set to follow different paths and this pattern may repeat.

Game Plan: We believe divergent central bank policy and improving global growth are two key drivers for improving international stock performance in 2016. Still, we do not expect the disparity of performance witnessed in prior periods as U.S. economic growth is likely to remain strong relative to many developed counterparts. Valuations among emerging market equities remain particularly attractive and potential earnings acceleration in Europe and Japan boost the allure of international stocks.

Large and Small Company Stocks

Large company stocks have weathered the start of Fed rate hikes better than small and mid cap companies over the 6- and 12-month periods following a rate increase.

Game Plan: Our large cap bias is fundamentally in response to large cap strength over the second half of the business cycle, but resilience during rate tightening cycles also plays a role. Over a longer 18-month time frame, small and mid cap stocks have enjoyed a resurgence, but this is in part due to small and mid caps anticipating an economic recovery in the aftermath of an economic slowdown. We believe the current hike is taking place in an aging economic cycle and we remain skeptical of a repeat of small and mid cap strength, maintaining a slight bias to large caps.

Stock Sectors

During the first six months following a Fed rate hike, technology is the only sector showing notable outperformance relative to the broad market as measured by the S&P 500. One year after the first rate hike, the technology sector has continued to exhibit strength, as have both the healthcare and

energy sectors, while the consumer discretionary sector has underperformed.

Game Plan: We believe technology may prove resilient in the face of rate hikes once again. Technology returns have varied significantly over rate hike periods, in part due to the late 1990s tech bubble, but we believe valuations, earnings potential, and increased corporate spending on technology as companies try to remain competitive may support performance. While stabilizing oil prices may limit the upside of consumer discretionary stocks in 2016, a strengthening job market may provide a lift to the sectors' historical trend of underperformance. On the other hand, stabilizing oil prices may help the energy sector start to rebound, although headwinds from the supply overhang may cap outperformance. Finally, the financials sector, a notable laggard one year after rate hikes, may follow a different drumbeat in this cycle. Financials are fundamentally stronger heading into this rate hike cycle than in the past and may weather rate hikes better, but the sector still faces some uncertainty if financial regulation continues to limit growth opportunities.

Bond Sectors

Treasuries have been the most sensitive to Fed rate hikes in the past and the current period is likely to be similar given still expensive valuations. More resilient sectors included emerging markets debt and high-yield bonds. The added income of these sectors has historically provided a buffer against rising rates.

Game Plan: More attractive valuations still make corporate bonds, high-yield in particular, part of a game plan to play defense against rising rates. Among high-quality bonds, mortgage-backed securities have shown resilience to Fed rate hikes, but more expensive valuations during the current environment leave us neutral on the sector. We expect municipal bonds to fare better during this rate hike cycle as limited net supply and attractive valuations on a long-term basis may continue to support the sector. Lower absolute yields and higher valuations of developed foreign bond markets limit the appeal of international bonds this period, and a break from the old routine may be warranted.

CONCLUSION

The launch of a rate tightening cycle will require investors to make adjustments in 2016 and beyond. ■

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 any individual security. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

Economic forecasts set forth 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 liquidity of the investment in a falling market.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond and bond mutual fund values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Asset classes represented: U.S. Stocks: S&P 500 Index; International Developed Stocks: MSCI EAFE Index; Emerging Market Stocks: MSCI Emerging Markets Index; Large Cap Stocks: Russell 1000 Index; Mid Cap Stocks: Russell Midcap Index; Small Cap Stocks: Russell 2000 Index; Treasuries: Barclays U.S. Treasury Index; Mortgage-Backed Securities: Barclays U.S. MBS Index; Investment-Grade Corporate Bonds: Barclays U.S. Corporate Bond Index; High-Yield Bonds: Barclays U.S. Corporate High-Yield Bond Index; Municipals: Barclays Municipal Bond Index; Emerging Markets Debt: JP Morgan Emerging Markets Global Index; Foreign Bonds: Barclays Global Aggregate ex-USD Index

The S&P 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 Russell Midcap Index offers investors access to the mid cap segment of the U.S. equity universe. The Russell Midcap Index is constructed to provide a comprehensive and unbiased barometer for the mid cap segment and is completely reconstituted annually to ensure that larger stocks do not distort the performance and characteristics of the true mid cap opportunity set. The Russell Midcap Index includes the smallest 800 securities in the Russell 1000.

The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

The Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Barclays U.S. Corporate High Yield Index measures the market of USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging markets debt.

The Barclays Municipal High Yield Bond Index is comprised of bonds with maturities greater than one year, having a par value of at least \$3 million issued as part of a transaction size greater than \$20 million, and rated no higher than 'BB+' or equivalent by any of the three principal rating agencies. (The long and the short are subindexes of the Municipal Bond Index, based on duration length.)

The JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

The Barclays Global Aggregate ex-USD Index is an unmanaged index considered representative of bonds of foreign countries.

The MSCI Emerging Markets Index is a free float-adjusted, market capitalization index that is designed to measure equity market performance of emerging markets.

The MSCI EAFE Index is a free float-adjusted, market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

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