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So, the Fed Finally Acts, and *Then* What?

That long-awaited interest rate hike by the Federal Reserve may well be at hand as early as the mid-December meeting of the Fed's Open Market Committee. So we might offer a few notes on the history of market reactions to periods of tightening in U.S. monetary policy.

Historically, risk assets often struggled the year following a secular change in the direction of rates, but the longer view is more positive. Of course, there is no real historical parallel to the Fed embarking on rate increases more than six years into an economic expansion.

Delayed Fed Rate Hikes

Trough of Recession	1st Rate Hike Post-Trough
March 1975	April 1976
July 1980	August 1980
November 1982	June 1983
March 1991	February 1994
November 2001	June 2004
June 2009	???

Source:
National Bureau of Economic Research

Eyeing that 36-month stretch from March 1991 to February 1994, it's encouraging to note the expansion's 10-year run accompanied by huge gains for stocks. In gauging the likely effect of an *initial* uptick in the Fed funds rate, the level of asset valuations and the level of that rate *relative* to historic norms would appear to be better predictors of absolute and relative returns.

Even if the Fed does hike, it may be premature to assume that the long bull market for bonds is over. Global growth indicators have disappointed lately, and there still appears to be a surfeit of global savings seizing on even the skinniest yields.

The economists at BCA Research looked at the last 17 instances of a Fed-initiated rate hike, dating back to the summer of 1971. For each of those occasions they compared the inflation-adjusted Fed Funds rate and the price-earnings ratio for the Standard & Poor's 500. Across those widely disparate time periods and circumstances, it is difficult to detect a definitive pattern for subsequent stock performance.

They note some alignment with the last Fed-initiated rate hike in June 2004. At that point, the inflation-adjusted Fed funds rate was negative like today, and the S&P 500's price-earnings ratio stood at a relatively high 22.9. The S&P dropped a couple percentage points in the three months following that first rate hike, but rallied off the second and third moves.

The fuller history simply provides too wide a range of outcomes to assign high predictive probability. Bonds outperformed stocks subsequent to just over half of those 17 periods, but still posted losses in absolute terms about half the time.

Unless you're a trader, it's the long term that matters. Secular bull and bear markets for bonds have tended to run two to four decades with the latest bull run dating to 1982. But a secular change in the bond market needn't be a calamity for well diversified portfolios.

Over the past four decades correlations between stocks and bonds have weakened, adding diversification value to a mixed allocation. And each decade's equity returns were driven by different themes that were hard to anticipate consistently.

Finally, we note that significant *downside* volatility usually results from events not widely anticipated. A long-awaited hike in the Fed funds rate shouldn't surprise *anybody*. ■

Budget Plan Clips Social Security Claiming Strategy

Late October brought a couple big surprises from the nation's capital. Congress and the administration worked out a two-year budget blueprint *without* all the political theater of past fiscal deadlines. And in the process they curtailed an increasingly popular strategy for boosting Social Security benefits. That strategy, called "file and suspend," worked as follows for couples who have reached full retirement age:

• One spouse files but suspends collecting benefits, thereby continuing to accrue higher *future* benefits.

• The other files to collect a *spousal* benefit (half the first spouse's full-retirement-age benefit) while continuing to accrue credits for a higher *future* payout based on his or her *own* work record.

The legislation appears to leave a window open to May 1, 2016, for those who can productively deploy the strategy. Those already collecting benefits worth half of a spouse's full-retirement-age benefit can keep doing so and later switch to their own larger benefit. But most *future* claimants will be filing for whichever benefit (spousal or their own) generates the higher payout. They'll no longer be able to claim and collect spousal benefits while continuing to accrue a larger benefit of their own to be triggered later.

Curtailing file and suspend may be understandably unpopular with couples nearing retirement, but it could help bolster Social Security's finances and simplify the task of setting a claiming strategy. And it's probably more consistent with the program's original intent. Who says the politicians never do *anything* about entitlements? ■

Uncertainty Looms Large in *Open* Election Years

Just in case you're looking for one more thing to worry about, 2016 is an *open* presidential election year. That means there's no incumbent running for the office, and when it comes to open election years, the stock market has a checkered past.

With the proviso that past performance is *not* indicative of future results, the eight open election years of the past century (1912-2012) have seen the broad U.S. equity market return an annual average of just 2.1%, compared to 10% for *all* of the century's election years.

Variability of returns also has been great. Half of the open election years saw stocks lose ground including declines of more than 30% in 1920 and 2008. On the other hand, the Dow Jones Industrial Average gained 16% in 1988 when George H. W. Bush claimed the prize, and a scintillating 49% in 1928 as Herbert Hoover won in a landslide. Most notably, those eight open election years produced the largest single-year gain *and* loss of the past 26 election years.

One can cite general factors as well as specific historical circumstances for the market's uneasy relationship with this political configuration. But it may just come down to the vagaries of small statistical samples and investors' distaste for heightened uncertainty. There's certainly plenty of that as we get set for another open election year. ■

Looking to Latin America's ANCEAM Six

A glance at the accompanying table shows the rough recent ride for investors in emerging markets. But those results are slanted to some large countries that have generated a lot of downbeat headlines.

South America in particular has seen large, resource-rich countries such as Brazil, Argentina, and Venezuela suffer a pronounced downturn in the commodities cycle, exacerbated by fiscal and economic policies that many view as inhospitable for capital. Similar policies have been pursued by Equador, Bolivia, and Nicaragua.

Emerging markets specialist Ashmore Group cites six regional players – Columbia, Peru, Panama, Costa Rica, El Salvador, and Guatemala – that have taken a different path with more upbeat results. These Andean and Central American countries have combined population of 108 million and annual economic output approaching $650 billion. Key metrics of their comparative health include the following:

2010–2014	ANCEAM Six	Latin America	Emerg. Mrkts
Growth	4.9%	3.7%	5.7%
Inflation	3.5	6.5	6.0
Govt. *Deficit* as % of GDP	2.4	3.3	1.7
Govt. *Debt* as % of GDP	35.9	48.8	39.1

Source: IMF World Economic Outlook

Ashmore notes two salient factors feeding the apparent progress indicated above. For starters, these countries have been relatively effective at resolving social conflicts and establishing some measure of political stability. Second, they've pursued relatively orthodox, free market economic policies, including free trade agreements with the U.S. and regional neighbors.

Beneath those overarching commonalities, the ANCEAM Six also display some marked contrasts. Colombia's government is still trying to reach an agreement to end a decades-long struggle with a violent revolutionary movement. Colombia also is an oil exporter while Peru's economy relies heavily on mining, so both have seen deterioration in their terms of trade during the current commodities slump.

The economies of Panama and Costa Rica are more services oriented with roughly twice the per capita GDP gross of Colombia and Peru. El Salvador and Guatemala are the poorest of the group with the former vulnerable to weather shocks and the latter prone to corruption and violence largely linked to the illicit drug trade.

For global investors, these countries may stand out as the best

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Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized through Dec. 4, 2015 ---**			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Blend)	0.7 %	14.9 %	11.9 %	6.6 %
Mid-cap Stocks (Blend)	− 1.3	13.7	10.4	6.7
Small-cap Stocks (Blend) †	0.5	13.0	9.9	6.5
Foreign Stocks (Large Blend) †	− 2.6	5.5	3.4	3.4
Diversified Emerging Markets †	− 14.3	− 3.3	− 3.6	3.9
Specialty Natural Resources	− 20.1	− 6.6	− 5.7	0.4
Specialty Real Estate	1.9	10.4	11.1	6.4
Moderate Allocation	− 0.7	8.1	7.4	5.4
Long-term Bond	0.2	2.0	6.9	6.3
World Bond †	− 5.2	− 1.3	1.4	4.0
High-Yield Taxable Bond †	− 2.7	2.4	4.8	5.9
Long-term Municipal Bond	− 2.8	2.1	5.1	4.3

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

Protecting Your Data This Tax Season

Another tax season will soon be upon us, and the IRS, state tax administrators, and tax software providers are poised to battle identity thieves who grab taxpayer data, file fraudulent returns and trigger refunds before those real taxpayers have even filed.

Last March the IRS held a Security Summit with state officials and tax industry players to beef up security measures for this filing season. They set new tax software standards for passwords, security questions, and lockout features. They added data elements to help flag fraudulent returns, and they agreed to frequent sharing of information to help monitor and combat new schemes.

They'll also be launching a campaign of YouTube videos, weekly Tax Tips, local events, and enhanced online information for consumers and tax professionals. It will focus on these familiar reminders for safeguarding your financial data:

• **Use security software** including a firewall and anti-virus protection. If tax returns or sensitive data are stored on computers, encrypt those files and use strong passwords.

• **Beware of phishing emails and telephone scams** in which identity thieves pose as organizations you recognize to induce you to provide Social Security numbers, passwords, or account information.

• **Take special care with email attachments** from any source you don't know well. Opening an attachment may install malware allowing a thief to access your computer files or track your key strokes.

• **Do not routinely carry your Social Security number** (SSN), and be sure to shred those old tax returns and other sensitive documents.

• **Check your credit report and Social Security record** to make sure nobody's using your credit or SSN for employment.

• **Think carefully about information you share on social media**.

For further information, check out *https://www.irs.gov/Individuals/Taxes-Security-Together*. 'Tis the season to be cautious. ■

Reining In the Deficit Didn't Require Such a "Grand Bargain" After All

Three years ago the received wisdom held that a freshly re-elected President Obama and Republicans in Congress needed to craft a grand, bipartisan bargain to address "runaway" federal deficits and debt. We suggested that nothing quite that grand was needed, as follows:

With modest but sustained economic growth, another extension of current income tax rates, and restoration of the full payroll tax rate, federal revenues should rise by perhaps $225 billion. And with continued restraint on spending growth, the deficit could slip somewhere below 6% of GDP.

For the record, that's pretty much what they did. And here's how it worked out through the government's recently completed fiscal 2015. ■

Federal Fiscal Year Revenue and Spending *(in billions of $)*

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Receipts	2,568	2,524	2,105	2,163	2,304	2,450	2,775	3,021	3,249
Outlays	2,729	2,983	3,518	3,457	3,603	3,537	3,455	3,504	3,688
Deficit	– 161	– 459	–1,413	–1,294	–1,300	–1,087	–680	–483	– 439
% of GDP	– 1.1	– 3.1	– 9.8	– 8.7	– 8.5	– 6.8	– 4.1	– 2.8	– 2.5

Source: The Congressional Budget Office

A Decision for Washington *GET* Account Holders

This past August the state of Washington suspended sales of its Guaranteed Education Tuition (GET) program and announced that GET account owners will be eligible for redemption opportunities and, in some cases, refunds.

GET is a prepaid college savings program under which Washingtonians could purchase units at a modest premium to *then-current* tuition and fees at the state's universities. GET guaranteed that those units could later be redeemed at the state universities' *future* tuition rates.

But with the recent passage of Washington's College Affordability Act, those tuitions may head *lower* over the next few years, undermining the program's value, especially for recent buyers. The program announced that GET account owners requesting a refund by December 15, 2016, can receive the *greater* of their cumulative contributions or the current payout of $117.82 per unit.

GET account owners will want to consider not only the prospective future value of their units, but also the timing of expected college expenditures and any cost of repositioning to a 529 plan account. Redemptions are subject to tax and penalty unless the proceeds are used for qualified education expenses *or rolled into a 529 plan* within 60 days. Such rollovers can only be performed once in a 12-month period.

With no state income tax benefit to factor in, Washington residents might consider a range of 529 plans from major investment companies. A 529 offers explicit, even unique, benefits in estate planning and inter-generational gifting – a flexible solution for parents, grandparents, other family and friends interested in helping to fund future education costs on a tax-favored basis.

As with all forms of goals-based saving and investment, time is of the essence. Your KMS investment professional can help you examine the alternatives. ■

Regrettably, Time Waits for No One

Younger readers might take note. According to a survey conducted by Financial Engines, 68% of adults over age 55 admit that they procrastinated on retirement planning. In and of itself, that's hardly surprising, but on average they admit to putting it off nearly *11 years* beyond the point at which they should have gotten started.

Financial Engines provides automated online assistance to millions of retirement plan participants. The reasons respondents gave for procrastinating may sound familiar.

What Got in the Way?

50%.... Stress
40%.... Other priorities taking precedence
24%.... Fear of being taken advantage of
23%.... Uncertainty on how to proceed
20%.... Believed it was just too difficult

Those obstacles can turn out to be rather expensive. Consider two 25-year-olds – one who starts setting aside 6% of pay at age 25 and one who waits until age 35. Assuming comparable, historical investment results for a diversified, moderate growth portfolio, the late starter will have to set aside nearly 12% just to catch up by age 65. And waiting until age 40 would then require setting aside 16.5% of pay to reach that same result at 65.

There are always reasons to wait, but time really *is* golden. ■

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prospects in a questionable neighborhood. As a group they've outgrown their Latin American brethren in the post-Cold-War era. But a period of slower growth for Peru and Colombia could make them vulnerable to political pressures for the kind of populist policies that have dominated some of the countries mentioned above.

Costa Rica looks poised for a growth upswing, but the government deployed significant fiscal stimulus with a marked increase in debt to GDP. El Salvador also has stimulated in the face of an export slowdown, and that higher debt burden could weigh even more heavily on this relatively poor country. Guatemala, on the other hand, has one of the region's lowest debt-to-GDP ratios, and its external balances have been steadily improving. Panama gets high ratings for its diversified services base, strategic infrastructure investments, political stability, and so-far skillful management of its sensitivity to shipping and the global business cycle.

In 25 years of monitoring the world's emerging investment opportunities, we've rarely had cause to focus on Latin America It will be interesting to see if the ANCEAM Six can help rehabilitate the region's image in the eyes of global investors. ■

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