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WEEKLY INVESTMENT COMMENTARY

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Cheering, Not Fearing, a Rate Hike?

A Rally With a Twist

Stocks rallied last week, recouping most of the previous week's losses. The tech-heavy Nasdaq Composite Index led the pack, gaining 3.59% to close the week at 5,104, while the Dow Jones Industrial Average rose 3.35% to 17,823 and the S&P 500 Index climbed 3.26% to 2,089. Meanwhile, the yield on the 10-year Treasury slipped from 2.28% to 2.26%, as its price rose.

Last week, investors looked past the tragic attacks in Paris and once again focused on central bank policy. The twist is that investors celebrated the potential for more divergence: tightening by the Federal Reserve (Fed) while the European Central Bank (ECB) pursues easing. Both trends have implications for investor positioning. We *would suggest* a continued overweight to hedged European equities while in the U.S. adopting a modest tilt toward large- and mega-cap stocks.

Central Bank Clues Move the Markets

Investors now appear to be treating a *December rate hike* by the Fed as a sign of economic stability rather than something to be feared. As such, investors were cheered by the minutes from the October Fed meeting, which were released last week. Consistent with recent statements, it now appears the Fed views the economy as strong enough to justify an initial rate hike, most likely in December. Although manufacturing remains weak — more evidence of which came this week in the form of anemic machine sales from Caterpillar, a six-year low in copper prices and a soft report from the Empire State Manufacturing Index — the broader economy is doing reasonably well while inflation and inflation expectations are stabilizing.

With fears over domestic growth waning, investors pushed up stocks and short-term yields, although commodities and credit mostly sat out the rally. Investors continue to demonstrate an appetite for companies perceived as beneficiaries of secular growth trends, notably technology. Last week, mobile payment maker Square Inc. surged on its first day of trading, counteracting concerns about the IPO price having been marked down from its previous valuation.

In Europe, the story remains somewhat different. European equity markets also rallied, with Germany doing particularly well, but the catalyst continues to be hope for more monetary stimulus, rather than signs of economic recovery. Investors got what they were looking for, with several ECB officials confirming the likelihood that the central bank will expand its quantitative easing (QE) program. ECB President Mario Draghi promised "we will do what we must to raise inflation as quickly as possible," a statement that had the predictable effect of driving stocks up while

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pushing bond yields even deeper into negative territory. The spread between German and U.S. five-year bond yields is now at its widest since the launch of the euro. Another implication is a sinking euro, which traded last week as low as 1.06 vs. the dollar, the weakest level since April.

With the euro falling and the ECB likely to expand its monetary stimulus serving as catalysts, we continue to suggest overweighting European equities.

Opportunities: European Equities and U.S. Large Caps

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Here at home, we have a modest preference for U.S. large-cap stocks. At first blush, this seems counterintuitive given expectations for a stronger dollar. Generally, a strong dollar is seen as more of a headwind for large caps, which have a greater exposure to international sales.

However, this year has demonstrated how the relationship is more complex. Yes, a stronger dollar has proved a headwind for large-cap company earnings, but small caps have actually been underperforming. Part of the reason has to do with why the dollar is appreciating: rising real (after-inflation) interest rates. U.S. real 10-year rates are up roughly 60 basis points (0.60%) since the end of January. This, in turn, is having an impact on small-cap valuations. Through October, S&P 500 Index multiples actually rose a bit. However, the price-to-earnings ratio on the Russell 2000 Index of small-cap stocks contracted by around 2.5%.

It should be noted that this is consistent with history. To the extent we see a gradual rise in real rates, it is also likely to keep small-cap valuations under pressure. As such, we favor a modest tilt toward large- and mega-cap names, which also have the advantage of cheaper valuations relative to the broader market.

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