Markets fell last week in response to the Federal Reserve (Fed) signaling that it planned to raise rates faster than investors expected. The S&P 500 Index was basically unchanged, while small-cap stocks shed 1.7%. International developed markets lost 0.6% and emerging markets dropped 2.4%. Bonds continued to decline, falling 0.6%, and commodities declined 1.1%.

The Fed increased interest rates 0.25% at its December meeting, a move we had thought likely after it declined to raise rates in September. By the time of the meeting, this increase was widely expected. However, additional communication from the Fed about its expectations for future rates rattled markets.

Even with the declines last week in stocks and bonds, most major indexes are up for the year and continue to outpace the very modest rates of returns available through cash investments.
For the second December in a row, the Fed voted to raise interest rates, by a quarter of a percentage point, to between 0.50% and 0.75%. Futures markets that trade on the expectation of changes in Fed policy had been pricing in the move at a 100% probability for weeks. Those levels of confidence were supported by continued positive economic news and Fed governors doing nothing to contradict market expectations in speeches and press releases.

While the rate increase was small, it sent a powerful signal. Gradually increasing rates is the most important step towards financial normalization taken in the aftermath of the global financial crisis of 2008. After a long period where rates were functionally zero, they are slowly starting to climb. Increasing rates communicates that the Fed believes the economic crisis is being overcome and we are moving back towards a healthier economy.

So, why doesn’t it raise rates faster? Continued concern over global economic growth remains at the top of the list of reasons why not. While global economies seem to be recovering, economic growth remains weaker than in the past and the Fed seems to favor being a little late to raise over being too early.

Exports also weigh in on the Fed’s decision-making. Fed rate hikes are often expected to raise the dollar because investors can earn a higher rate of interest on dollar-denominated, short-term investments. The recent increase in the U.S. dollar makes it more expensive for international purchasers to buy U.S. goods, shrinking exports. A decline in exports, through currency appreciation, means the economy won’t expand as quickly if the dollar had stayed low. Therefore a rate hike that pushes the dollar higher slows the economy by increasing borrowing costs and by reducing exports. Because the Fed may get a double dose of slowing from just one hike, it may not need to hike rates as quickly.

2017 will be an interesting year for watching the Fed. How effective the hikes will be at slowing growth, whether low employment will continue to push inflation higher, and possible infrastructure spending all make predicting rates challenging. The next section discusses the Fed’s market expectations for 2017, and potential risks to investors.
Because the rate hike was firmly priced into investors’ expectations, the market’s reaction reflected guidance the Fed provided regarding its intentions in 2017. The graphic to the right shows the “dot plot,” which summarizes the expectations of each Fed governor or voter. Based on the dots for year-end 2017, two officials expect one hike next year, four expect two hikes, six expect three hikes, and five expect more than three hikes. (See the boxed area in the chart.)

Voters and the average Fed official expect, at most, three hikes in 2017. Those expectations stand in stark contrast to the futures market, which places only a 30% chance that there will be one hike by mid-year.

The difference between market expectations and the Fed’s expectations provides a possible source of risk for the market. I emphasize possible source of risk because the same situation was true at the end of 2015. The Fed expected to raise rates numerous times and it only raised rates once. Yet, as mentioned in the introduction, 2016 has been a good year for most markets.

From the perspective of investors, there are two possible risk scenarios. First, the Fed could raise rates too quickly and push the economy back into recession. While the economic recovery keeps chugging along after over seven years, the rate of growth remains slow. If the Fed raises rates too quickly, then economic growth generally slows.

Second, the economy could be stronger than expected, prompting rates to move higher more quickly than market participants expect. Higher borrowing costs translate into less economic activity and lower profits — both negatives for stock investors.

When analyzing policy impact on markets, keep two things in mind. First, the Fed’s estimates of economic growth and the number of times it plans to hike rates have been consistently too high. If I had to pick between the market expectations and the Fed, based solely on recent history, I would pick the market every time.

Second, the motivation of the Fed broadcasting its plans to hike three times may not be designed to predict, but rather to communicate. First, the Fed is communicating to other central banks how its policies might change. Second, the Fed is reaffirming its commitment to keeping inflation under control. By showing its vigilance, it reassures investors.

When the Fed says it plans to raise rates three times next year, it might be saying that it plans to raise rates three times, at most, and only if the economy warrants it. Otherwise it will hike fewer times, like it did last year. But, don’t get the impression that it isn’t concerned about inflation. It is, and it will take the steps needed to keep it under control.

If that is the case, the market and the Fed may not be all that far apart.
Driving in Seattle is difficult. The north-south Interstate 5 corridor can take hours to navigate at the wrong time of the day. For visitors (like me), a few ill-timed lane changes and a wrong turn can make the process even worse.

William Beaty, an electrical engineer in Seattle who moonlights as a traffic researcher, believes individuals can make a difference in the overall traffic flow by doing a few simple things differently than most drivers. Not only might these techniques make traffic flow better, they also provide some good advice for investors as we enter a new year.

Beaty’s research suggests overall traffic speed slows when too many drivers seek to jump into small holes, or have to slow to accommodate other drivers needing to switch lanes. Instead, he recommends creating gaps that other drivers can use to change lanes, exit, or merge into. By allowing other drivers to merge without significantly slowing, traffic behind them can benefit. Instead of the emotionally challenging stop-and-go traffic drivers detest, traffic maintains a steadier and higher average speed.

Investors would benefit from taking these ideas and applying them to their portfolios. Here are a few ideas investors can adapt from Beaty’s research.

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<th>Recommendation</th>
<th>Effect</th>
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<td>Avoid short-term aggressive moves.</td>
<td>Drivers who rapidly switch lanes for minimal advantage increase their risk in pursuit of minimal gain — steady risk exposure will likely produce better results.</td>
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<td>Don’t gawk at accidents.</td>
<td>Like drivers who slow traffic to stare at a fender bender, slowing your portfolio by decreasing its risk after a decline just makes it harder to catch back up — focus on the long-term.</td>
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<tr>
<td>Plan for changes.</td>
<td>Drivers who need to cross four lanes of traffic to exit and investors who adjust portfolios at the last possible instant rely on the whims of other drivers/investors to get where they want to go — planning ahead has its advantages.</td>
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<td>Use technology to your advantage.</td>
<td>Getting drivers and investors to buy into these ideas may be difficult, but technological improvements, whether self-driving cars or smart beta ETFs, can make implementing them much easier.</td>
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Our approach to markets matches these ideas well. CLS clients generally have a Risk Budget score that keeps their risk at a steady level suitable to their individual investment time horizon and capacity for risk. We have been big proponents of smart beta ETFs to implement strategies that used to be available only at much higher prices. While opportunities to jump in with both feet or hop out for short times seem tempting, we recommend finding a Risk Budget that allows portfolios to stay invested and benefit from the long-term performance of capital markets.
The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The S&P 500® Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000® is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The MSCI EAFE Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI Emerging Markets Index is a composite index which tracks performance of large and mid-cap firms across 21 countries classified as emerging market countries. The Barclay’s Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Barclay’s Capital 1-3 Month U.S. Treasury Bill® Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities and represents 20 commodities that are weighted to account for economic significant and market liquidity. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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The Expectations Dot Plot is as of December 14, 2016. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant’s judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.