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Why This Is Still a Great Time to Invest

Now that Janet Yellen (http://www.forbes.com/profile/janet-yellen/) and the Federal Reserve have all but made it official that a rate hike is inevitable, the question becomes how soon and how much? While consensus may be growing that the first of the coming rate increases will commence in June, I think the Fed will likely be more cautious and begin its "liftoff" during the September 16-17 meeting.

The good news is the period before the Federal Reserve raises rates is historically a great time to invest. Over the past six tightening periods since 1980, the S&P 500 has returned 23.5 percent on average in the nine months prior to the first rate increase. Assuming the next tightening cycle begins in September, the nine-month period this time around began in mid-December. Since that time, a number of indicators, including my favorite, the New York Stock Exchange Cumulative Advance/Decline Line, show that the stock market is improving and can sustain its upward momentum.

Looking beyond the myopic recent churn and burn, the important macro indicators remain positive, and nothing has occurred to fundamentally alter our positive outlook.

The period prior to a rate hike has also been a favorable environment for corporate credit. High-yield bonds and bank loans have outperformed investment-grade bonds on average by 4.0 percent and 1.6 percent, respectively, in the nine months leading up to the start of the last three tightening cycles. Even after the Fed begins to raise rates, tightening of monetary policy does not necessarily lead to an immediate widening of credit spreads. During four of the last five tightening cycles (1983, 1986, 1994 and 2004), default rates continued to fall for nearly the entire tightening period and ultimately ended lower than they were when the Fed started to tighten. In the past four instances where the Fed began raising rates following an extended period of monetary accommodation, high-yield spreads tightened on three occasions. On average, high-yield spreads tightened for nine months after the first Fed rate hike in a cycle.

All of this, combined with positive historical performance prior to past rate hikes, leads me to believe that a positive environment for U.S. equities and credit will continue between now and the first Fed rate hike.

But the question no one seems to be asking is once the Fed commences down the road of raising rates, how far will they ultimately go? Based on research we've conducted on the impact of higher rates on the U.S. debt burden, it appears the terminal value for the fed funds rate—the point at which the Fed stops tightening in a cycle—is around 2.5 to 3 percent, a lot lower than many people expect.

After the September liftoff, the Fed is likely to raise rates by 25 basis points every other meeting. Practically, this means the overnight rate should be in the 50- to 75-basis-point range by the start of 2016.

Longer term, the Fed will likely continue to tighten at a steady pace until it nears the terminal rate in the cycle, which I believe will occur toward the end of 2017 or early 2018 in the range of 2.5 to 3 percent. Supporting such a ceiling on the fed funds rate is research that shows a close historical relationship between the debt-to-GDP ratio in the economy and the terminal fed funds rate.

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