

## IAQF Academic Problem

With the Federal Reserve poised to begin a new credit tightening cycle, investors need to consider the potential impact of a rate increase on equities, bonds, commodities, and portfolio allocation decisions. Any rate increases that ensue will be following a period of unusually long monetary stimulus and near-zero interest rates, which have distorted markets in unprecedented ways. Unwinding this stimulus may create significant risks for investors.

The implication of rising interest rates is obvious for fixed income instruments, but for other asset classes, the effects are less clear. For example, rising US interest rates are generally seen as bad news for emerging markets, because the strengthening of the US dollar could cause trouble in countries where firms have borrowed heavily with American currency, and the weaker domestic currencies could make it more difficult to pay back the dollar debt. In addition, because commodities such as oil, gold, and cotton are priced in US dollars, a stronger US dollar increases the price of commodities and emerging economies that rely heavily on raw materials and commodities may be placed at a disadvantage. However, emerging-market economies have become a bigger, significantly more complicating factor in global capital markets as these nations have grown in size and influence. Economies are connected as never before, and developed and emerging economies are often closely linked.

Conventional wisdom has historically suggested an inverse relationship between interest rates and stock valuations. The logic is that when interest rates fall, fixed income investments become less competitive because of their lower yields, and therefore, stocks become more attractive; conversely, when interest rates rise, fixed income investments become more competitive because of their higher yields, and stocks become less attractive. But there are other factors: rising interest rates increase the cost of capital, which can slow consumption, manufacturing, and production. Moreover, if higher interest rates further strengthen the dollar, American goods will become more expensive abroad and US manufacturing may continue to suffer from weak demand. Experience dictates that not all sectors of the economy will respond in the same manner. During past periods of rising rates, non-US developed markets, emerging markets, real estate investment trusts (REITs) and dividend stocks outperformed the MSCI USA Index and Russell 3000 Index a majority of the time, while small-cap and preferred stocks underperformed during those periods. Individual sectors within the US market experienced a range of returns during rising rates. Historically, Financials and Utilities underperformed and Industrials outperformed.

Your task is to analyze the effects that the Fed policy of increasing interest rates will have on the equity markets, debt markets, currency markets, and more generally on international financial markets, and to develop a portfolio to take advantage of the impending changes.