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There is an old Wall Street adage that "bull markets climb a wall of worry." There has certainly been plenty of wall to climb over the past few years as a number of concerns ranging from the health of the economic recovery to heightened geopolitical tensions have led to some intense hand-wringing by investors at times. While many of these issues have caused stocks to pull back temporarily, the market has ultimately been able to shrug each of them off and continue its ascent to record highs. With the economy showing recent signs of strengthening, the next significant challenge to the market will likely be related to the Federal Reserve unwinding its easy-money policies that have played a key role in the multi-year market run.

With the Fed already comfortable enough with the strength of the economy that it is set to end its bond-buying stimulus program in a few weeks, investors have increasingly begun to monitor its plans for raising interest rates. The Fed has kept the federal funds rate (the overnight interbank lending rate which influences other borrowing costs throughout the economy) at near zero since December 2008 in an effort to nurse the economy back to health following the Great Recession. The stock market has been a beneficiary of the Fed's actions as the historically low interest rate environment has made stocks more attractive relative to interest-bearing assets. It is understandable then that investors are concerned over how future rate hikes will impact stocks. The ultimate reaction by the market is likely to depend greatly on how quickly rates rise. A rapid spike in rates could very well jolt the market, while a gradual rise over a prolonged period should prove to be far more manageable.

As the Fed has repeatedly stated, the timing and pace of its rate hikes will be dictated by the economic data. The economy has certainly shown encouraging signs of progress over the past several months, with manufacturing growth surging, the labor market improving and business spending finally starting to pick up. Still, economic growth throughout the recovery has been uneven, and the Fed would like to see the recent progress gain further traction before boosting rates. In particular, the Fed is looking for additional improvement in the labor market. Though jobs growth has been solid and the unemployment rate has steadily declined to 5.9% from 7.3% a year ago, wage growth remains stagnant and a significant number of people have had to settle for part-time positions or have stopped looking for work altogether. With inflation still running well below its

2% target, the Fed appears to have plenty of flexibility to let the recovery continue to play out for a while before taking action.

Our expectation is that the Fed will wait until the middle of next year to make its initial rate increase and will then continue with additional hikes at a measured pace over the course of a few years. Though the Fed is not likely to begin raising the federal funds rate until next summer, other rates will likely start to creep up well before then in anticipation of the Fed's rate hikes. In fact, as the economy has strengthened and the belief that the Fed will begin to raise rates next year has started to take hold, the yield on the ten-year Treasury note has inched up after hitting a low for the year in August. Still, with the Fed in no rush to aggressively raise the federal funds rate, we think it is unlikely that other rates will rise rapidly. Additionally, with rates on sovereign debt in Europe and Japan sitting well below comparable U.S. Treasury yields, there should continue to be solid global demand for U.S. debt, which should also help to prevent rates in the U.S. from spiking dramatically higher.

With the Fed poised to start raising the federal funds rate in the coming months and the long journey toward the normalization of interest rates set to begin, the bull market will be faced with yet another in a long line of challenges. While the slowly rising interest rate environment that we envision over the next few years will likely serve as a bit of a headwind to stocks and could very well increase market volatility as investors sort out its implications, we think the market will ultimately be able to successfully absorb its impact so long as corporate earnings growth is strong. A strengthening economy, which is likely to be a prerequisite for Fed rate hikes, should provide a favorable backdrop for solid earnings growth. In fact, earnings growth has already started to pick up over the past couple of quarters as the economy has improved.

Given the strong gains in equities over the past few years, the market as a whole is no longer cheap. The S&P 500 now trades at a price-to-earnings ratio that is slightly above its historical average, and there are fewer bargains today than there were a few years ago. Even so, there are still a number of well-run, financially strong companies that have yet to fully participate in the market rally, and we will continue to take advantage of such solid long-term investment opportunities .

Sincerely,

Alison J. Gamble
Gamble Jones Investment Counsel

P.S. As a reminder, you are required to take a minimum distribution from your traditional IRA and other retirement accounts each year upon reaching the age of 70 *Yi*. You must take a minimum distribution from an inherited IRA every year regardless of your age. Please contact your tax advisor regarding your specific withdrawal requirements.