Ritholtz Wealth Management
90 Park Avenue, 18th floor
New York, NY 10016
212-455-9122

July 2014 Strategy Letter

"What do rising rates mean for equities?"

"Faced with the choice between changing one's mind and proving that there is no need to do so, almost everyone gets busy on the proof."
-John Kenneth Galbraith

Wall Street is notorious for creating simple rules of thumb. While some of these heuristics are based on past experience, these truisms are frequently exaggerated to the point where they lose whatever kernel of usefulness they may have once contained. All too often we see simple observations from very specific and limited sets of circumstances take on a life of their own.

This leads to a set of beliefs we often describe as "Conventional Wisdom" - nuggets of knowledge assumed to be true, but often unsupported by actual data.

I was reminded of this problem with rules of thumb recently when responding to the single most common question we hear today from clients: "*What do rising rates mean for the stock market?*"

Indeed, this has been a question on the tip of nearly everyone's tongue ever since the Federal Reserve began curtailing stimulus this past December. The implied concern is that the end of the Fed's programs of Quantitative Easing (QE) and Zero Interest Rate Policy (ZIRP) will have a negative effect on the equity portion of your investment portfolios.

This concern is understandable. The Fed's support for stocks now and during recoveries past has been among the most frequently discussed topics amongst investors for years.

Before we delve into the real impact of rising rates on the stock market, let's first discuss why there is such fear around the subject to begin with.

The primary reasons people are concerned with increasing interest rates are:

- Fear of *slowing economic growth*

- Concerns that goods and services purchased *using credit* become more expensive

- Worries of a profit squeeze when *operating costs rise.*

- Remembrance that economic cycles end when the Federal Open Market Committee (FOMC), in its inflation-fighting mode, *tightens too much* and causes a recession.

These are all, of course, legitimate concerns for investors. However, there are greater truths about rising rate cycles that ought to be central to this conversation.

The primary reasons we should be encouraged by increasing interest rates are:

- They mean the *economy is improving*, leading to higher demand for expansion capital, mortgages and credit - any increase in *demand for capital* naturally leads to an increase in the price of money.

- A *normalization of rates* is a sign that the previous credit crisis has gotten further and further behind us.

- Higher rates means the Fed has been successful in their fight against *Deflation*.

- Rising rates suggest more companies are *seeking to expand*, hire and engage in R&D and CapEx spending - all areas we've been hoping to see perk up for almost a decade now.

As you can see from these examples, there are both good and bad attributes of rising rate environments, defying any sort of conventional wisdom shorthand. No two economic cycles are ever identical.

Each of the points in our positive and negative scenarios have occurred in a variety of different eras and every economic cycle contains its own specific combination of variables. When all of these inputs interact, we end up with a broad range of possible outcomes. The net impact is that there is no rule of thumb that will give us a simple "*When Rates do X, Stocks do Y*" sort of formula.

This does not stop the majority of the Wall Street *commentariat* from repeating the unproven myths and assumptions about what happens next. As an antidote to all the old wives' tales we decided to take a look at the *actual* history of interest rate increases over the past century and the real impact they've had on the stock market.

What the data shows is something far more nuanced and complex than you might have assumed.

I asked our director of research, Michael Batnick, to examine the periods in which there is interest rate volatility in either direction. At the close of this letter, we've included a table with some insights that may surprise you. (*See* page 4 for Five Surprising Facts About Rates Today)

But more importantly for our purposes today, Michael took a look at the impact of rate movements on the S&P 500, our stand-in for the broader US equity market. There have been 86 past instances during which interest rates changed over the course of a calendar year. The effects of these changes produced a diverse array of outcomes in the market, thanks to the interaction of a variety of factors - rates are just one factor of many that exert an influence on profits and price multiples, after all. To give this exercise some context, please remember that equity prices are higher seven out of every ten years in general.

Rising stocks, rising rates

Our most significant finding was that when rates were rising, the most prevalent condition for stocks was that share prices were rising too. During a year in which rates rose, 73.9 percent of the time – 34 out of 46 instances – equity prices also moved higher. This combination of events - stocks and rates rising in concert - occurred 39.5 percent of the time.

When we looked at the circumstances of these periods of rising stocks and rates, we found that the average 10-year bond yield was 5.11 percent, the P/E ratio of the S&P 500 averaged about 15, and inflation as measured by the Consumer Price Index (CPI) was over 4 percent. The average S&P 500 increase during these periods was almost 21 percent.

Rising rates, falling stocks

In the dozen instances when rates rose and stocks fell, the S&P 500 lost almost 16 percent on average. At the same time, the 10-year bond yield averaged over 6 percent, the P/E ratio for stocks was a historically low 12.57, but inflation was high, averaging 6.8 percent during these periods. This combination of high rates, hot inflation, and cheap (and getting cheaper) stocks typically implies a recessionary environment.

Falling rates, rising stocks

Let's look at what happened when rates fell and stocks rose: There were 40 such instances of falling rates, and 65 percent of the time stocks moved up. The 10-year Treasury yield averaged 5.12 percent, CPI inflation was low at 3.3 percent and the S&P 500's P/E ratio was elevated at 16.23 percent. Stocks typically gained over 18 percent in those years.

Falling rates, falling stocks

During the 16 percent of the time when rates fell and stocks also fell, equities dropped on average by 12.3 percent. These joint falling occurrences tend to happen during deflationary eras or during secular bear markets.

It has been taken as a matter of faith - *conventional wisdom* - that higher interest rates are bad for equities. What little historical basis for this belief there is comes to us from an era of double-digit bond yields and very high inflation. During the *stagflation* era of the 1970s, it was market strategist Marty Zweig who cautioned investors, "Don't fight the Fed." Zweig meant that investors should avoid equities when the Fed was raising interest rates. His advice was sage then but what was true in one era of high interest rates and higher inflation is not destined to be true today, as we have just seen in the data itself.

Indeed, just because the Fed was cutting rates did not by itself alone mean that it was an ideal time to be long stocks. Look no further than the bear market for stocks that occurred between 2001-03 for an example of where fighting the Fed was profitable.

Therefore, our key takeaway would be this: When *inflation is high, and rates are going up from already high levels*, we see a very negative impact on stocks. When inflation is subdued, and rates start increasing from low or very low levels, the impact on stocks is positive.

This latter case is most similar to the environment we find ourselves in today, thus our skepticism around the popular idea that normalizing rates will be a negative for the S&P 500. It may work out that way, but the data suggests that this is not the most likely outcome.

As we have seen, rising interest rate environments have different outcomes, depending upon a variety of factors. If history holds true, rising rates in 2014 and 2015 should not have a deleterious impact on either the economy or the equity markets. There are a variety of inputs we look at each week, month and quarter. We will continue to observe and analyze these to see if any changes in our portfolios are in order.

That said, we would not expect the normalization of interest rates, including a modest eventual increase in the 10-year Treasury to between 4 percent and 5 percent, to be fatal to the current bull market.

Barry Ritholtz
CIO, Ritholtz Wealth Management

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<u>Five Surprising Facts About Rates Today</u>:

1. Short-term interest rate are *still* close to zero. In the beginning of the year, 78 out of 78 economists surveyed forecast rising rates and falling bond prices. Halfway through 2014, rates have fallen and bonds have rallied.

2. Long term rates at developed nations are also falling, despite (perhaps because of) widespread expectations of a rise. The 10-year US Treasury note yielding 2.6% is 16th of 20, far above Japan, Germany, Switzerland and Hong Kong (see chart).

3. Inflation remains benign, at very low levels worldwide. European inflation is now only 0.50%, while CPI in the US is at 2.0%.

4. Deflation – falling prices in a negative spiral – is the bigger threat to the economy than inflation. After decades of deflation and recession, Japan is finally seeing modest increases in inflation.

5. Despite the predictions of ballooning government deficits causing a debt problem, the U.S. deficit continues to shrink. It was running at $1.4 trillion in 2008 and 2009, per year during the following the financial crisis, and is now running at $400 billion – and falling.