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How Will Rising Rates Impact Stocks?

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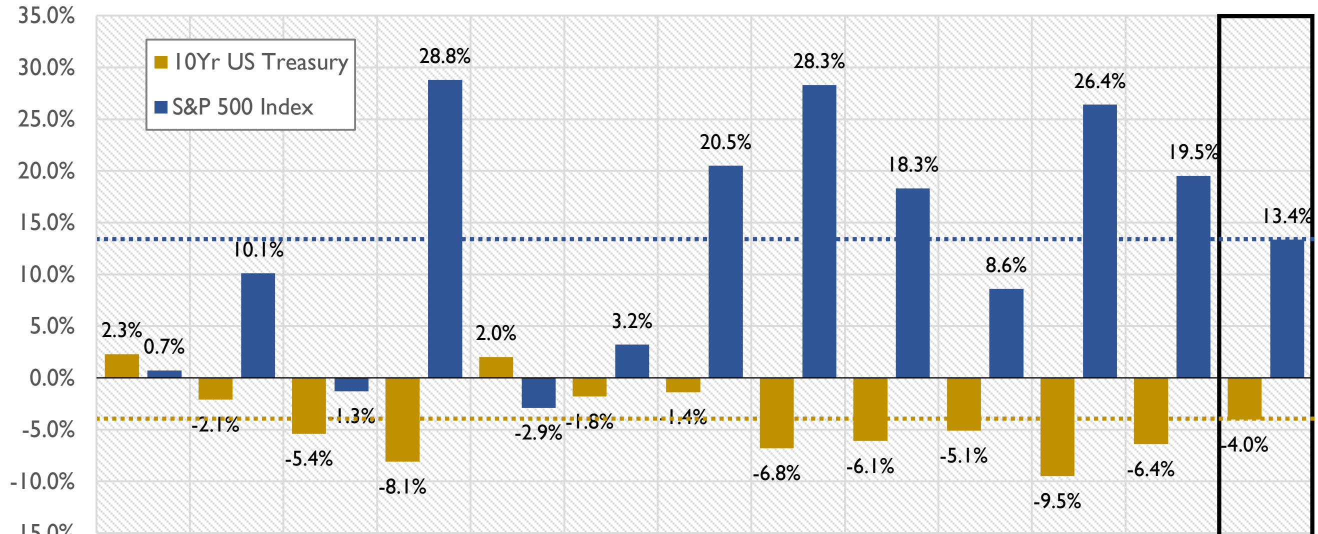
Now that the Fed has decided to begin raising rates, the focus has turned to how these decisions might affect stock returns. The chart below reports the return impact for the dozen times during which the 10-year US Treasury Bond rate increased by more than one percent over the last 45 years. The annual S&P 500 return averaged 13.4% over these 12 periods, higher than the long-term average of 10%, and was positive in nine of these periods.

RISING INTEREST RATE IMPACT ON BONDS AND STOCKS (1971 – 2015)



PERIOD	1	2	3	4	5	6	7	8	9	10	11	12	AVG
START	NOV 71	SEP 77	MAY 83	SEP 86	JUL 89	APR 93	JAN 96	OCT 98	MAY 03	JUL 05	JAN 09	JUL 12	
END	SEP 75	SEP 81	JUN 84	SEP 87	AUG 90	NOV 94	MAR 97	JAN 00	MAY 04	JUN 06	DEC 09	AUG 13	
MOS.	47	49	14	13	13	20	15	16	12	12	12	14	20
RATE Δ	2.6%	8.6%	3.6%	2.7%	1.0%	1.9%	1.3%	2.2%	1.3%	1.2%	1.6%	1.3%	2.4%

Source: Morningstar, Compustat

It makes sense that the 10-year US Treasury Bond lost an average of 4.0% annualized as the 10-year rate increased due to the mathematical inverse relationship of bond prices to yield. The fact that stocks tend to perform well during these periods is a less discussed phenomenon. This means rising interest rates should be a cause for excitement rather than concern for equity investors.

Since last month's election through December 27, the 10-year US Treasury Bond rate has already jumped by 0.80%, while the S&P 500 gained 8.6%. It appears that growth and inflation are on the rise, positive signs for continued stock market performance. Stocks do well in this kind of environment as the benefits of earnings growth more than offset the negative impact of rising rates on stock valuations. Furthermore, stocks have proven to be an excellent hedge against inflation.

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From the Behavioral Viewpoint

What is going on?

1. The Fed and what they will do with interest rates is an example of an **availability cascade**, when a topic is so prevalent in the media that it dominates our decision making. The conventional wisdom, repeated over and over again, is that rising interest rates will hurt stock returns as the Fed "takes away the punch bowl". However, the table provided shows just the opposite because the improving economic environment is what triggers the rate increase in the first place.
2. Another popular notion is that "all things being equal" rising rates make fixed income more attractive on a relative basis and therefore money should flow out of equity and into fixed income. This is an example of a **heuristic** where we over-simplify things. Of course, all things are not equal with rates that are historically low and changes that are likely to be gradual.
3. Most fixed income assets are hurt by rising interest rates and so it is not surprising that some people may think stocks will be hurt as well. This is a **representativeness bias**, based on the incorrect assumption that interest rate changes are the main drivers of stock returns as they are for bond returns.

What can we do?

1. Work with a financial advisor using a needs-based planning approach. Design investment portfolios with a well-planned strategic asset allocation based on long-term goals to help avoid emotional reactions to market noise and media hype.
2. Be wary of a traditional 60%/40% asset allocation. This plan worked fine when bonds delivered a 6-8% yield. Today's 10-year US Treasury Bond yields just over 2%, which won't even keep pace with long-term inflation. To meet today's demand for investment income put alternative income sources such as dividend paying stocks to work in your income portfolio.
3. If you feel compelled to invest based on macro-economic events, hire a truly active manager that specializes in making investment decisions based on macro-economic conditions. Allocate a reasonable portion of your investments to that strategy and give it sufficient time to perform.

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