Quarterly Investment Outlook

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Advisor's Commentary

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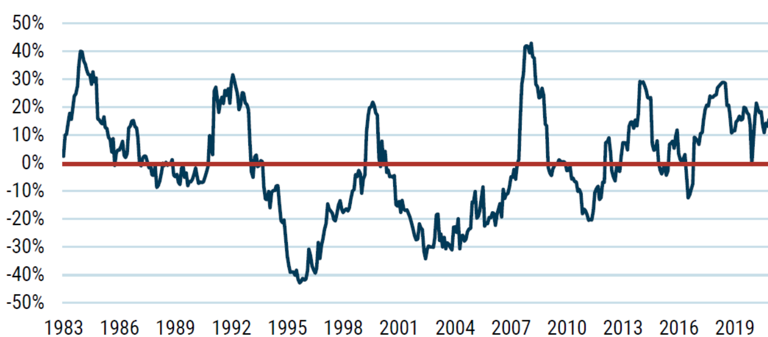
A popular topic currently discussed is the stock market's vulnerability to rising interest rates. This narrative revolves around the idea that with higher discount rates, future earning streams are worth less and thus, present equity valuations should contract. Theoretically, the narrative makes sense as discounting future cash flows at an increasingly higher rate would lower the present value of those cash flows, rendering the value of an investment lower. The infamous "Powell Pivot" in 2019 exemplifies this view. After successive interest rate hikes, originally started in 2016, the Fed chief unexpectedly reversed course and cut rates in early 2019. The cuts occurred after the US equity market had fallen 20% from its peak in late 2018. Subsequently, the market rallied strongly giving support to the idea that equities are highly sensitive to interest rate moves. This narrative gained ground again this year when equity market volatility resurfaced and longer dated bond yields rose. Initially it served to explain why growth stocks were losing out to value stocks, as the latter's shorter "duration" stood to benefit when rates rose. As fitting as this narrative seems, GMO, the asset manager, points out that over time there is little correlation between the relative performances of growth and value stocks when interest rates move. Rather, their findings show that the durations of these two styles are much closer when analysing for the drivers of return, such as valuation, growth, income, and rebalancing effects.

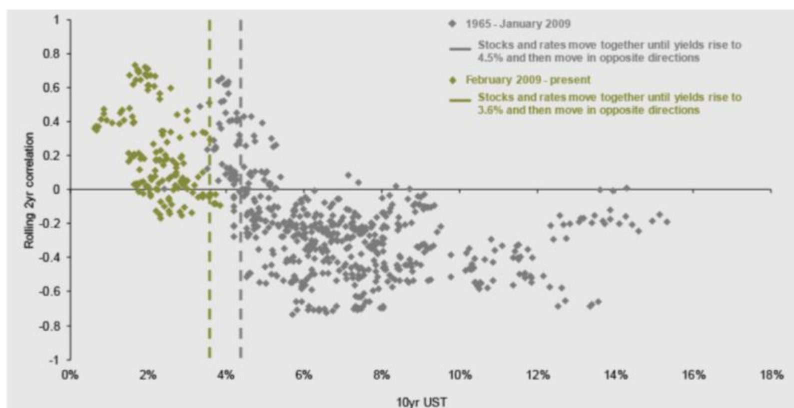
Little Consistency Between Interest Rate Moves and Equity Style Performance[1]

36-Month Correlation between Change in US 10-Year Yield and Return on the Relative Performance of Russell 1000 Value – Russell 1000 Growth



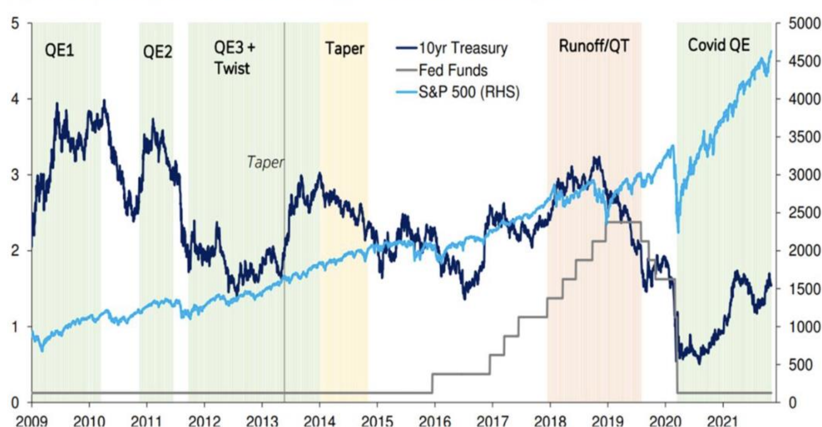
The Level of Interest Rates Affects Equity Prices[2]

Rolling 2-year Correlations between S&P 500 Returns and 10-Year Treasury Yields at Various Interest Rate Levels



Equities Have Been Beneficiaries of Accommodative Policies[3]

Figure 1: US yields, equities and Fed Funds through various Fed balance sheet phases



Source: [1] GMO, [2] JP Morgan Asset Management, [3] DoubleLine Capital

However, the rate narrative, but not necessarily the duration argument, has merit. Interest rates are the primary mechanism for valuing assets and rate changes affect their pricing. Interest rate policy shapes the term structure of rates. The shape of that curve, i.e. the level of short and long-term government bond yields, influence other asset prices significantly. Conceptually, if bond yields rise to a level where the expected return approaches the return of a higher risk asset, say equities, capital will flow to the less risky asset due to the expected superior risk adjusted return. Typically, a negative revaluation of the risky asset then occurs until it exhibits return and risk characteristics that increases the opportunity cost of holding the lower risk asset. According to JP Morgan Asset Management, there is a threshold before that revaluation takes place. Prior to the Great Financial Crisis (GFC), correlations between equity returns and interest rate moves turned negative when yields rose to 4.5%. Since then that threshold has shrunk to 3.5%, likely reflecting what impact prolonged periods of artificially low interest rates have had on asset prices. However, both findings imply that above a certain level risky assets become increasingly sensitive to the direction of interest rates. Simply put, the competition for capital intensifies. Perhaps this threshold is even lower now after all the monumental amounts of liquidity provided. Furthermore, quantitative easing undoubtedly assisted in propping up asset prices. Since QE's inception, central bank balance sheets and equity market capitalizations have expanded in accord. With quicker removal of stimulus and more rate hikes, coupled with slower economic growth, the set up for a rerating of risk capital is highly plausible. During previous rate hikes in 1994, 1999, 2004, and 2016, earnings multiples, on average, contracted about 20%. Earnings, however, grew over 20% year on year during those cycles, eventually bringing valuations to levels where the return and risk properties for equities improved significantly. Ultimately, and not surprisingly, subsequent equity bull markets drove earnings multiples higher.

Disclosure: The information contained herein has been obtained from sources believed to be reliable but the accuracy of the information cannot be guaranteed. Past performance is no indication of future results.

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