THOUGHT FOR THE WEEK

# WILL RISING RATES CAUSE STOCKS TO CRASH?

Global Financial Private Capital

## SYNOPSIS

- Several investors have voiced the concern that higher rates are the beginning of the end for this bull market.
- A rising interest rate, on its own, is not enough to estimate the future direction of stock prices.
- The decision to sell stocks simply because rates are rising could risk leaving an investor out of attractive returns for quite some time.

## THE IMPACT OF RISING RATES

The U.S. has not experienced a rising interest rate regime for over a decade, and several investors have voiced the concern that higher rates signify the beginning of the end for this equity bull market.

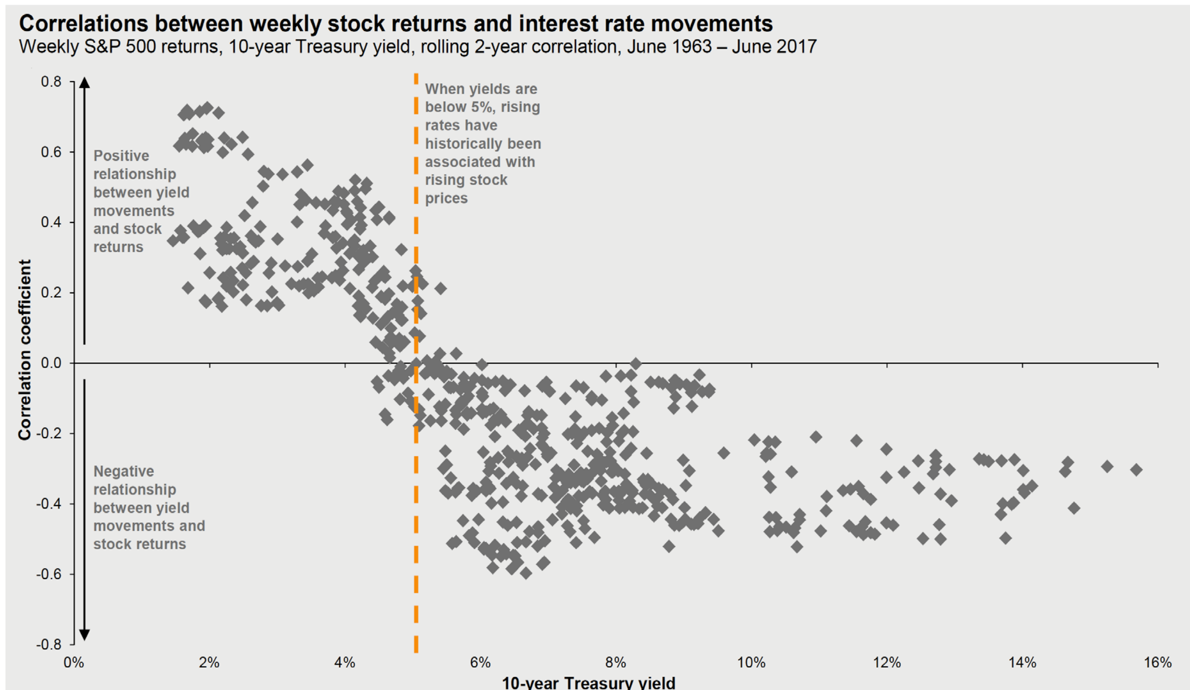
Consumer and business spending fuel the majority of economic growth, and since most major purchases are done on credit, interest rates are vital to the health of the economy. For example, if the interest rate on a car loan doubled from 4% to 8%, then fewer consumers will buy cars because the interest payment would eat up more of their monthly income.

High interest rates have historically led to recessions for this very reason, and we all know what recessions do to the stock market, so let's see if history can offer any insight into the impact of rising rates on the stock market. The chart below is a good starting point.

The horizontal axis is the 10-year Treasury yield, which represents long-term interest rates, and the vertical axis measures the relationship between the S&P 500 and interest rate movements.

A dot below the 0.0 level indicates a negative relationship between the S&P 500 and interest rate movements. Meaning, when interest rates have been at 10% and moved higher, the S&P 500 has gone down. This behavior confirms the notion that rising interest rates can hurt stocks.

At 10%, consumers are mostly likely not spending much already, and to move them even higher is going to choke off the economy that much more. Less spending equates to lower profits for companies and ultimately sends stock prices down.




Source: FactSet, Standard & Poor's, FRB, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.
*Guide to the Markets – U.S.* Data are as of June 30, 2017.

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A dot above the 0.0 level indicates a positive relationship between the S&P 500 and interest rate movements. Meaning, when interest rates are at 2% and move higher, the S&P 500 goes up. This behavior contradicts the notion that rising rates hurts stocks.

At 2%, consumers are still spending because rates this low tend to equate to early stages in an economic recovery. This point in the cycle is very good for stocks because the economy is growing faster but not overheating to where the Fed feels they need to intervene.

*"...a rising interest rate, on its own, is not enough to estimate the future direction of stock prices."*

Therefore, the only conclusion that can be derived from historical data is that a rising interest rate, on its own, is not enough to estimate the future direction of stock prices. We must also consider the current interest rate level because this is a critical factor in determining the health of the economy.

## WHEN TO WORRY

The orange-dotted line at 5% indicates the threshold where an interest rate hike has gone from helping stocks to hurting them. Currently, the 10-year Treasury yield is around 2.2%, so we are far away from this line in the sand.

Unfortunately, it's not as easy as owning stocks until the 10-year Treasury yield hits 5% and then selling. This threshold is based on historical averages, and there was nothing average about the aftermath of the financial crisis.

The last time the Fed moved short-term interest rates this low was during the Great Depression, and repeating these extreme measures most likely shifted the goalpost to where a 5% threshold may no longer apply.

This uncharted territory forces investors to consider other factors before estimating when stocks may start to feel the pressure from rising interest rates. The most important of all is inflation because this has become the Fed's main focal point now that unemployment has reached all-time lows.

Currently, the Fed's favored measure of inflation is below their target, and this has historically been a very good time to own stocks. Until inflation creeps higher and stays there for more than a few months, the Fed has little incentive to push our economy to the point where future rate hikes become a headwind for stocks.

## IMPLICATIONS FOR INVESTORS

I enjoy traveling to meet with investors, and as a result, I spend a lot of nights in hotels. One thing I have learned during my time on the road is that hot water in most hotels is very dangerous. I will never understand why property managers allow the temperature to get to the point where it can melt aluminum, but it's nearly universal across the country.

Therefore, every time I shower in a hotel, I follow an iterative process to ensure I don't end up in the hospital. I turn the hot water knob ever so slightly, checking the temperature along the way before I move it higher.

The Fed follows a similar process when raising interest rates. They know that if they ramp up interest rates too far too fast, the economy will get scolded. This is why they have only been raising by 0.25% each time since December 2015. They want to see how the economy reacts before continuing, but this is incredibly difficult to get right.

When I test the water temperature in my shower, I get near immediate feedback, so I know exactly when to stop. The U.S. economy is too large and has too many moving parts for anything to be immediate, so a change to interest rates, no matter how big or small, can take up to a year to feel the effects.

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This lack of timely feedback is the precise reason why the Fed continually screws up and drives our economy into a recession. At some point down the road, this will happen again, and stocks will fall into a bear market. But it is highly unlikely that this will happen anytime soon.

*The bottom line* is that stocks have experienced tremendous gains in the early innings of rising interest rates, and the decision to sell stocks simply because rates are rising could risk leaving an investor out of attractive returns for quite some time.

Sincerely,

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