

Do Stocks Really Like Higher Rates?

LPL Research recently penned an interesting post entitled "Why Stocks Like Higher Rates."•

"What does it mean for equities if rates and yields do indeed go higher? Fortunately, to the surprise of many, stocks historically do very well when rates increase. Since 1996, stocks gained all 11 times we saw higher rates,?"•

HIGHER RATES ARE USUALLY A GOOD THING

Rising Rates Start Date	Rising Rates End Date	Duration (Months)	Change in 10-Year Treasury Yield	S&P 500 Gain/Loss
12/26/62	8/29/66	45	1.7%	18.3%
3/16/67	12/29/69	34	3.6%	1.3%
3/23/71	8/7/73	29	2.2%	6.3%
12/17/73	8/26/74	8	1.5%	-22.2%
12/19/74	9/16/75	9	1.3%	21.3%
12/20/76	2/27/80	29	6.7%	5.1%

Here is the conclusion:

*"Not to be outdone, the current period of higher rates began in September 2017 and the S&P 500 is up another 11% since then. History suggests higher rates may be a good thing and should the 10-year Treasury yield break about **the critical 3% area, this could be further support for the bull market.**"*

The analysis is actually backwards.

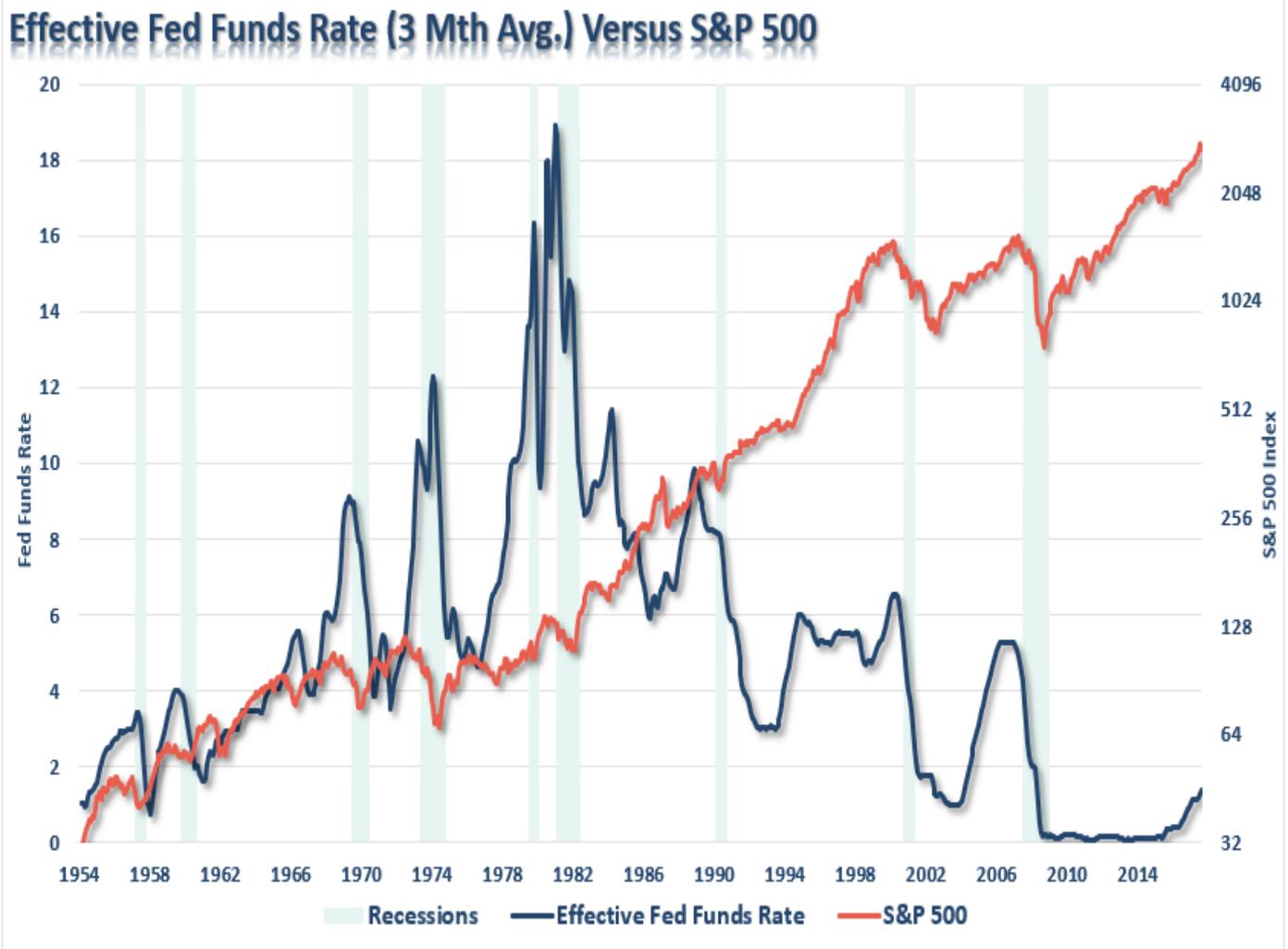
Michael Lebowitz just wrote about this in [Fasten Your Seat Belt, Turbulence Ahead](#). His article is worth reviewing to see what has really happened over entire rate cycles and not hand chosen dates to prove a point.

While the markets, due to momentum, may choose to ignore the effect of "monetary tightening" in the short-term, what about the longer-term? For example, one might think based on the LPL table above that the financial crisis of 2008 was positive for stock investors. The analysis shows that in 8 of the 15 months spanning from March 2008 to June 2009, equity holders had gains. While that is true, equity holders that did not get the memo with specific dates on when to buy and sell lost over 50%.

As shown in the table below, the bulk of losses in markets are tied to economic recessions. •

Recession Start	Recession Finish	10-Yr Rate Start Of Expansion	10-Year Rate At Recession	Total Rate % Change	Recession Length - No Of Months	Recovery Length - No Of Months	S&P Peak Prior To Recession	S&P Trough During Recession	S&P 500 Decline - Peak To Trough
Oct-1873	Mar-1879	5.32	5.50	3.34%	66	35	Aug-1871 100.23	Jun-1877 67.37	-32.79%
Mar-1882	May-1885	5.50	3.62	-34.12%	39	21	Jun-1881 172.11	Jun-1884 125.44	-27.12%
Mar-1887	Apr-1888	3.62	3.55	-2.12%	14	26	Nov-1886 186.98	Mar-1888 152.73	-18.31%
Jul-1890	May-1891	3.55	3.52	-0.71%	11	19	Sep-1889 177.61	Dec-1890 144.97	-18.38%
Jan-1893	Jun-1894	3.52	3.75	6.53%	18	17	May-1892 196.89	Jul-1893 143.86	-26.93%
Dec-1895	Jun-1897	3.75	3.59	-4.31%	19	23	Sep-1895 175.11	Aug-1896 151.00	-13.77%
Jun-1899	Dec-1900	3.59	3.12	-13.05%	19	20	Mar-1899 229.32	Sep-1900 185.01	-19.32%
Sep-1902	Aug-1904	3.12	3.26	4.49%	24	32	Jun-1901 281.44	Oct-1903 190.40	-32.35%
May-1907	Jun-1908	3.26	3.74	14.62%	14	18	Jan-1906 290.08	Nov-1907 173.92	-40.05%
Jan-1910	Jan-1912	3.74	3.91	4.64%	25	11	Aug-1909 266.28	Jul-1910 217.31	-18.39%
Jan-1913	Dec-1914	3.91	4.45	13.81%	24	43	Aug-1912 251.57	Nov-1913 198.36	-21.15%
Aug-1918	Mar-1919	4.45	4.53	1.78%	8	9	Dec-1915 229.06	Jan-1919 118.40	-48.31%
Jan-1920	Jul-1921	4.53	4.97	9.73%	19	21	Jul-1919 136.02	Dec-1920 87.36	-35.77%
May-1923	Jul-1924	4.97	4.26	-14.29%	15	26	Oct-1922 138.00	Oct-1923 115.52	-16.29%
Oct-1926	Nov-1927	4.26	3.43	-19.60%	14	20	Sep-1926 189.43	Nov-1926 185.46	-2.09%
Aug-1929	Mar-1933	3.43	3.42	-0.17%	44	49	Sep-1929 450.28	Jun-1932 87.29	-80.61%
May-1937	Jun-1938	3.42	2.64	-22.79%	14	79	Nov-1936 308.60	Apr-1938 173.34	-43.83%
Feb-1945	Oct-1945	2.64	2.36	-10.80%	9	36	Sep-1939 229.32	May-1942 121.08	-47.20% Declined In Adv Of Recession
Nov-1948	Oct-1949	2.36	2.33	-0.99%	12	44	Jun-1948 173.70	Jun-1949 145.47	-16.25%
Jul-1953	May-1954	2.33	2.93	25.66%	11	38	Aug-1952 234.71	Sep-1953 215.29	-8.27%
Aug-1957	Apr-1958	2.93	3.93	34.13%	9	23	Apr-1956 444.55	Dec-1957 353.42	-20.50%
Apr-1960	Oct-1960	3.93	4.28	8.91%	11	105	Jul-1959 509.17	Oct-1960 448.73	-11.87%
Dec-1969	Nov-1970	4.28	7.65	78.74%	12	35	Jan-1966 730.34	Jul-1970 483.20	-33.84%
Nov-1973	Mar-1975	7.65	6.73	-12.03%	17	57	Jan-1973 691.71	Sep-1974 335.05	-51.56%
Jan-1980	Jul-1980	6.73	10.80	60.48%	7	11	Sep-1976 455.84	Apr-1980 316.47	-30.57%
Jul-1981	Nov-1982	10.80	14.28	32.22%	17	91	Nov-1980 395.00	Mar-1982 291.80	-26.13%
Jul-1990	Mar-1991	14.28	8.47	-40.69%	9	119	Aug-1987 716.60	Oct-1990 572.54	-20.10%
Mar-2001	Sep-2001	8.47	4.89	-42.27%	9	72	Aug-2000 2,139.43	Sep-2001 1,458.13	-31.84%
Dec-2007	Jun-2009	4.89	4.10	-16.16%	19	105	Jul-2007 1,816.93	Mar-2009 885.86	-51.24%
Averages Since 1871									
Mean		4.80	4.76	2.24%	18.24	41.55			-29.13%
Median		3.91	3.91	-0.17%	14.00	32.00			-26.93%

However, while it is true the historical average interest rate where a recession was triggered was near 5%, **averages are very deceptive**. Of more importance than the nominal level, are the actions of the Federal Reserve which are typically reflected by the 10-year Treasury rate. The graph below shows the confluence of Fed Fund increases and recessions. The table below the graph shows the date of the first Fed rate hike, the number of months until the next event which was either a recession, a market correction or both, and the percentage decline in the stock market.



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Date Of First Increase In 3-Mo Avg EFF	Total Increase In 3-Mo Avg EFF	No. Of Months From Increase To Recession	No Of Months Between Increase In EFF And Subsequent Market Peak	% Decline In Market	Comments
7/1/1954	2.2	33.0	30.0	-13.2%	
8/1/1958	2.9	19	17.0	-6.12%	
8/1/1961	---	---	8.0	-20.09%	<i>Rising Rates Triggered Correction In Market / No Recession</i>
10/1/1962	---	---	40.0	-17.35%	<i>Rising Rates Triggered Correction In Market / No Recession</i>
11/1/1967	---	---	14.0	-29.02%	
9/1/1961	7.48	98	---	---	<i>Market Correction Already In Progress From 11/1/1967</i>
5/1/1971	6.40	29	21.0	-43.35%	
5/1/1977	11.65	35	---	---	<i>Recession With Only Minor Market Correction</i>
8/1/1980	9.05	11	46.0	-19.38%	<i>Recession With Major Market Correction</i>
5/1/1983	---	---	6.0	-9.90%	
11/1/1986	3.02	36	10.0	-26.84%	<i>1987 Market Crash</i>
4/1/1988	---	---	27.0	-14.78%	
1/1/1994	---	---	0.0	-4.67%	<i>Market Enters "Irrational Exuberance"</i>
1/1/1994	2.46	84	15.0	-42.55%	<i>"Dot Com" Crash</i>

The point is that in the short-term the economy and the markets (due to the current momentum) can DEFY the laws of financial gravity as interest rates begin to rise. However, as rates continue to rise they ultimately act as a "brake" on economic activity. Think about the all of the economic areas that are **NEGATIVELY** impacted by rising interest rates:

- 1) Rising interest rates raise the debt servicing requirements which reduces future productive investment.
- 2) Rising interest rates will immediately slow the housing market taking that small contribution to the economy away. People buy payments, not houses, and rising rates mean higher payments.
- 3) An increase in interest rates means higher borrowing costs which leads to lower profit margins for corporations. This will negatively impact corporate earnings and ultimately the financial markets.
- 4) One of the main arguments of stock bulls over the last 5-years has been the "**stocks are cheap based on low interest rates.**" When rates rise, the market becomes **overvalued** very quickly.
- 5) The massive derivatives and credit markets will be negatively impacted.
- 6) As rates increase so does the variable rate interest payments on credit cards and home equity lines of credit. With the consumer being impacted by stagnant wages and increased taxes, higher credit payments will lead to a contraction in disposable income and rising defaults.
- 7) Rising defaults on debt service will negatively impact banks which are still not as well capitalized as most believe, due to the suspension of FASB Rule 157, and are still burdened by large levels of debt.
- 8) Many corporate share buyback plans and dividend payments have been done through the use of cheap debt, which has led to increased corporate balance sheet leverage. This will end.
- 9) Corporate capital expenditures are dependent on lower borrowing costs. Higher borrowing costs leads to lower capex.
- 10) The deficit/GDP ratio will soar as borrowing costs rise sharply. The many forecasts for lower future deficits will crumble as new forecasts begin to propel higher.

I could go on, but you get the idea. But LPL was addressing the 10-year rate specifically. As I stated, the Fed can push rates in the short-term, but the lifting of rates on the short-end tends to lead to an inverted yield curve. **The claim that higher rates lead to higher stock prices falls into the category of "timing is everything."**



Date Start	Int. Rate Low	Date End	Int. Rate Peak	Total % Chg.	S&P 500 Peak	S&P 500 Trough	S&P 500 Return	Recession / Crisis
2/1/1957	3.3	10/1/1957	4.0	18.86%	7/1/1957	4/1/1958	-12.72%	Recession / During
5/1/1958	2.9	9/1/1959	4.7	60.27%	8/1/1959	3/1/1960	-7.37%	Recession / 2 Mo. Later
7/1/1965	4.2	9/1/1966	5.2	23.33%	1/1/1966	10/1/1966	-17.35%	Vietnam Starts
3/1/1967	4.5	5/1/1968	5.9	29.30%	9/1/1967	3/1/1968	-7.01%	Recession
8/1/1968	5.4	5/1/1970	7.9	45.94%	12/1/1968	7/1/1970	-28.89%	Recession / During
11/1/1971	5.8	8/1/1973	7.4	27.37%	1/1/1973	12/1/1974	-43.36%	Recession During
11/1/1973	6.7	8/1/1975	8.4	24.81%				
12/1/1976	6.9	3/1/1980	12.8	85.59%	9/1/1976	3/1/1978	-15.79%	Oil Crisis
6/1/1980	9.8	9/1/1981	15.3	56.65%	11/1/1980	7/1/1982	-19.37%	Recession
5/1/1983	10.4	6/1/1984	13.6	30.64%	10/1/1983	7/1/1984	-9.88%	Recession
1/1/1987	7.1	10/1/1987	9.5	34.46%	8/1/1987	12/1/1987	-26.84%	October 1987 Crash
12/1/1989	7.8	9/1/1990	8.9	13.39%	6/1/1990	10/1/1990	-14.78%	Recession
9/1/1993	5.4	11/1/1994	8.0	48.51%	1/1/1994	4/1/1994	-5.45%	Asian Contagion
10/1/1998	4.5	1/1/2000	6.7	47.02%	8/1/2000	10/1/2002	-42.47%	Recession / Tech Bust
6/1/2003	3.3	5/1/2006	5.1	53.45%	7/1/2007	3/1/2009	-50.21%	Recession / Financial Crisis
12/1/2008	2.4	4/1/2010	3.9	59.09%	4/1/2010	7/1/2010	-9.82%	Euro Crisis
10/1/2010	2.5	2/1/2011	3.6	40.94%	2/1/2011	9/1/2011	-11.15%	Debt Ceiling Debate
7/1/2012	1.5	1/1/2014	2.9	89.54%	7/1/2015	2/1/2016	-9.70%	Brexit/Taper Tantrum
7/1/2016	1.5	2/1/2018	2.9	93.33%	2/1/2018	???	???	Trade Wars
Mean				43.84%			-20.15%	
Median				43.44%			-15.29%	

In every case, increases in interest rates negatively impact equity prices. It is just the function of "time" until "something breaks." While the analysis from LPL is certainly well intentioned to support the "bullish case," what it fails to address is the **full-cycle effect from rate hikes**. LPL is correct that historically interest rate increases have led to higher stock prices. Since troughs in interest rates are typically associated with market bottoms (as money flows from "risk" to "safety,") **the time to BUY equities** is when rates begin to rise, not near the end of a rate/economic cycle. **The same premise holds true for valuations**. While the mainstream analysis is not to fear rising interest rates in the short-run, as longer-term investors it is crucially important to the preservation of investment capital to understand the dynamics of increasing interest rates and heed the warning being offered by rising rates.

Summary

Here are the things that you need to know:

- 1) There have been **ZERO times** when interest rates have risen that did not eventually lead to negative economic and financial market consequences.
- 2) The median number of months following the initial rate hike has been 17 months. However, given the confluence of central bank interventions, that time frame could extend to the 35-month median or late-2018.
- 3) The average and median increases in the 10-year rate before negative consequences have occurred has historically been 43%. We are currently at double that level.

4) Importantly, there have been only two times in recent history that the Federal Reserve has increased interest rates from such a low level of annualized economic growth. Both periods ended in recessions.

5) The ENTIRETY of the "bullish" analysis is based on a sustained 34-year period of falling interest rates, inflation and annualized rates of economic growth. With all of these variables near historic lows, we can only really guess at how asset prices, and economic growth, will fair going forward.

6) Rising rates, and valuations, are indeed bullish for stocks when they START rising. Investing at the end of rising cycle has negative outcomes.

What is clear from the analysis is that bad things have tended to follow sustained interest rate increases. While the markets, and economy, may seem to perform okay during the initial phase of the rate hiking campaign, the eventual negative impact leads to losses in investment capital.

Emotional mistakes are 50% of the cause as to why investors consistently underperform the markets over a 20-year cycle. (The other 50% is lack of capital) For all the reasons currently prognosticated that rising rates won't affect the "bull market," such is the equivalent of suggesting "this time is different." It isn't. Importantly, "This Cycle Will End," and investors who have failed to learn the lessons of history will once again pay the price for hubris.