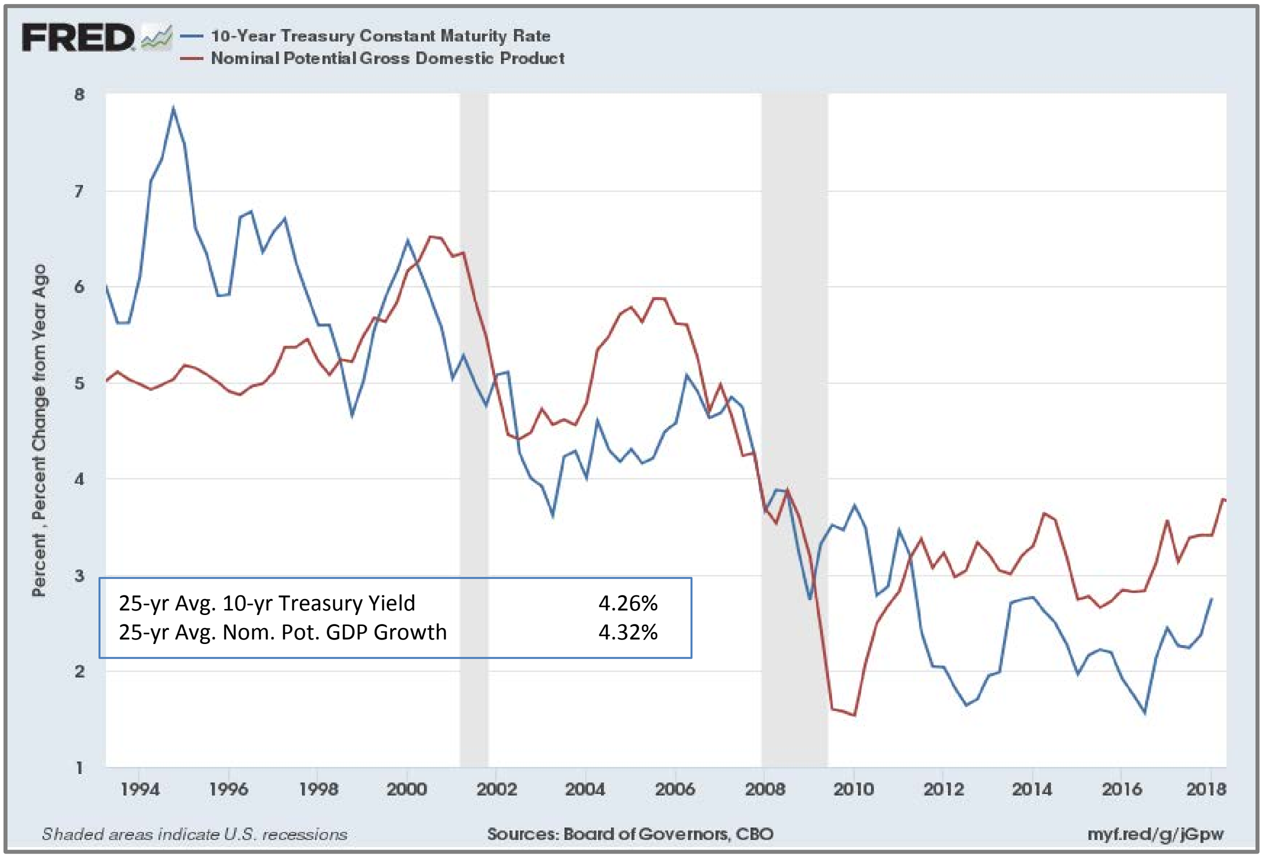
The Return to "Normal": Should Investors Fear Rising Interest Rates?

One of the more talked about rationales for the surge in market volatility in 2018 has been the uptick in interest rates to start the year. Following several years of extremely accommodative monetary policy to help extract the economy from the 2008-2009 financial crisis, the Federal Reserve has now raised the Fed Funds rate six times over the past three years, sending both short and long-term interest rates higher in the process. This is significant in that an overaggressive Federal Reserve has led to three of the past five economic recessions and each of those recessions has coincided with a bear market in equities (as defined by 20% peak-to-trough losses in the S&P 500). Thus, investors may be concerned that we are heading down the same road again. In this month's Insights, we will provide some perspective on the recent increase in interest rates and argue that, at this point, investors should welcome rather than fear a return to "normal" rates.

Historical Perspective

With the 10-year Treasury yield now testing the 3% level, many in the investment community have fixated on 3% as a psychologically important level that, if eclipsed, could spell trouble for the markets. To put it bluntly, we don't agree. As highlighted in the chart below, the 10-year Treasury yield has averaged 4.26% over the past 25 years, making the current level near 3% appear still quite low in its historical context. Of course, the growth rate of the economy has trended lower over time, but even when considering the widely held assumption that the 10-year yield should track nominal GDP growth (real GDP + inflation), 3% is still well below the current nominal potential GDP growth of just under 4%. Notably, as shown below, the increase in long-term rates since 2017 has coincided with a material uptick in potential GDP growth, which indicates to us that rates are rising for a good reason.



Given that the real estate bubble of 2008-2009 is still fresh in the minds of investors, the recent increase in interest rates, and in turn mortgage rates, has reignited fears of another housing-related slowdown. On this issue, we would point to both the historical context for mortgage rates as well as continued housing affordability as reasons for investors to look elsewhere for the catalyst of the next downturn. As noted by J.P. Morgan Asset Management, the average mortgage rate in the U.S. is now 4.47%, up from its lows in recent years, but still well below the 8.07% average over the past 40 years. Additionally, the average mortgage payment represents just 13.4% of household income today (versus a 19.3% 40-year average), likely indicating that U.S. households are well positioned to absorb a moderate increase in mortgage rates.

Finally, turning to the relationship between interest rate movements and stock prices, rising rates do have the impact of increasing the discount rate used to value future cash flows, thereby lowering present values for equity valuations, all else being equal. In reality, however, this phenomenon can be more than offset by the improving earnings growth and cash flow prospects that are leading to higher rates in the first place. Historically, it has been the starting level of interest rates that has determined whether rising rates would be a positive or negative for stock returns. Since 1963, movements in the 10-year Treasury yield have had a positive correlation with stock prices (higher rates = higher stock prices) when the starting yield is below 5% and a negative correlation (higher rates = lower stock prices) when the starting yield is above 5%. Assuming this relationship holds in this cycle and rates are in fact rising due to better growth prospects, higher rates are not likely to represent a major headwind for equities in the near term.

Implications for Investors

While the reaction of market participants to higher interest rates has thus far been more skittish than welcoming, for the reasons highlighted above, we believe investors should view this normalization as appropriate and even positive from a long-term perspective. For equity investors, we believe higher rates portend a healthier economy with less need for abnormal accommodation to grow. For fixed income investors, higher rates cause unpleasant declines in bond values in the near-term, but allow for an improved return outlook for bonds over the long run. Of course, various equity and bond market segments will do better or worse depending on their sensitivity to higher rates, so where appropriate, we think certain alternative investments such as income-producing real estate and private credit may offer an attractive substitute for assets most negatively correlated with rising interest rates.

Although we are not sounding any alarm bells today, we would become more concerned on interest rates if we sensed they were rising for reasons other than an improving economy or they approached levels exceeding nominal GDP growth. We are also mindful of the fact that the shape of the yield curve matters just as much, if not more, than the level of long-term rates, so we are monitoring the spread between the 1-year and 10-year Treasury as an indicator of monetary policy becoming too tight for the economy. An inverted yield curve (where the spread between the 1-yr and 10-yr Treasury turns negative) has been a remarkably accurate forecaster of economic recession, preceding all nine recessions since 1955. In each case, the yield curve inverted 6-24 months prior to the beginning of the recession. As of the end of April, this spread registered at 0.68%, down from a

1.62% spread at the beginning of 2017 following four additional Fed rate hikes. While the shape of the yield curve is not yet a reason for concern, it is something we will be watching closely going forward.

As always, we greatly value the confidence you have placed in MAI to help you navigate these evolving market conditions. Please feel free to contact us with any questions or concerns.