Perspective

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At a Glance...

Higher Interest Rates

Will they bring a market correction?

By Randy Williams-Gurian

The US financial markets continue to set new record closes, but the enthusiasm for moving the US markets higher seems to be lacking. Investors may be reacting to a longer-than-average bull market in the United States, as the current bull market cycle is 6 years and counting. In addition, there has not been a meaningful market correction in more than three years. The average market correction is 10 percent once a year. Moreover, there appears to be some hesitation to purchase US equities due to a strengthening US dollar, which cuts into revenues generated overseas by US conglomerates. The Federal Reserve decision to likely raise interest rates in the coming fall also appears to be weighing on investor minds. Yet financial markets can rise when the Federal Reserve is tightening monetary policy.

Overseas market indexes are on fire as their interest rate worries are nonexistent due to ECB and the Bank of Japan easy money policies. The German DAX index jumped more than 21 percent in the first quarter alone and the Shanghai Composite Index is up 52 percent year-to-date through May 25 as main land China is relaxing some of its market controls. In addition, the Japanese, or Nikkei index has reached its highest level since April 2000. Both the Japan and developed Europe stock markets are benefiting from quantitative easing and weaker currencies versus the US dollar. Germany and Japan are major export economies and their weaker currencies are having a favorable impact on growth and their respective industrial economies. The United States finished its quantitative easing program in 2014 and has been suggesting a rise in interest rates is ahead. Essentially, the United States was the first developed economy to print money and the other two major developed economies have now followed suit.

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What do rate hikes mean for stock market investors?

Now the fun begins. How fast will the Federal Reserve raise US interest rates and what does a rising rate environment mean for equity and bond investors? Higher interest rates does not necessarily lead to a bear market for equities. Contrary to conventional wisdom, research shows that when the Fed raises rates, the stock market tends to do quite well, as long as the pace and the magnitude of the rate hikes are reasonable. One must consider the fragility of the current economic recovery and what significantly higher interest rates would do to the anemic recovery in the US. In addition, Janet Yellen has been very transparent about her support for lower rates and is likely the most dovish Federal Reserve chairperson the markets have experienced in years. Therefore, the likelihood of significantly higher interest rates is low which should translate into higher stock prices eventually.

What does well when rates rise?

According to an article in *Fortune*, Michael Batnick and Joshua Brown studied a period of time going back to 1976 where there were eight rate hike cycles and the Fed raised rates at least three times. For the one year period leading up to the rate hike cycle, the S&P 500 did exceptionally well returning on average 18.11 percent. For the one-year period after the rate hike cycle the S&P 500 advanced 14.6 percent on average. During the cycle itself the markets generally did perform below average but are still positive returning compound growth of 8.3 percent.

Foreign stocks tend to significantly outperform US stocks before and during rate hike cycles. In the one year prior to a Fed rate hike their research showed the MSCI EAFE Index generated an average annual return of 25 percent versus the typical 11 percent rolling 12-month periods.

What does poorly when rates rise?

Bonds or fixed income investments behave poorly, but not nearly as poorly as assumed, during a rising rate environment. The long end of the yield curve does very poorly historically when interest rates rise.

Why is asset allocation key to being successful during a rising rate environment? Knowing what you own and making sure you have exposure and over weighting international markets is key. In addition, the financial markets will likely initially sell off as the Federal Reserve moves to raise rates, this is not a time to react and sell equity positions during the market

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downturn. Never follow your emotions when it comes to the stock market. Investors should stay focused on the long term and avoid the temptation to sell assets during market pullbacks.

Historically, indexing does poorly during periods of rising interest rates. This appears to already be the case in 2015. Active managers have outperformed passive or index managers by a wide margin thus far in 2015. In addition, active management by their definition, should outperform indexing as long as your team of professionals continues to scan the market for the top performing managers in each asset class. This will more than make up for the difference in expenses versus the index funds. Remember indexing means you will own every stock in a respective index taking the good with the bad and you will only track or earn the market rate of return. An active strategy using the top managers combined with strategically under weighting or over weighting a particular asset class often performs better. In fact there is empirical research which confirms that asset allocation drives over 90 percent of portfolio performance and stock picking plays a very small role.

Where does that leave us?

It is important to work with an experienced team of professionals who understand the importance of manager selection and portfolio design. This will help to create a framework for success for your investments and your money. Stay on the path and receive good guidance along the way and your investment results will work for you versus you working for your results.

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