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Why rising rates won't derail stocks

March 2021 | Russ Koesterich, CFA, JD

Russ discusses how history suggests that higher interest rates can help, not hinder, stocks.

As the vaccine rollout accelerates and case growth turns meaningfully lower, it seems that higher rates have replaced the virus as investors' biggest concern. History would suggest that this fear is somewhat exaggerated. While higher interest rates can temporarily disrupt stocks and often cause violent sector rotations, in the past higher rates have been associated with higher, not lower stock prices.

To start it's important to note that the empirical relationship between rates and stocks is more complicated than textbooks suggest. In theory, all else equal higher interest rates should lead to lower stock prices as you discount future cash flows with a higher rate. Although the logic holds, this model ignores the fact that higher rates are generally accompanied with faster economic and earnings growth.

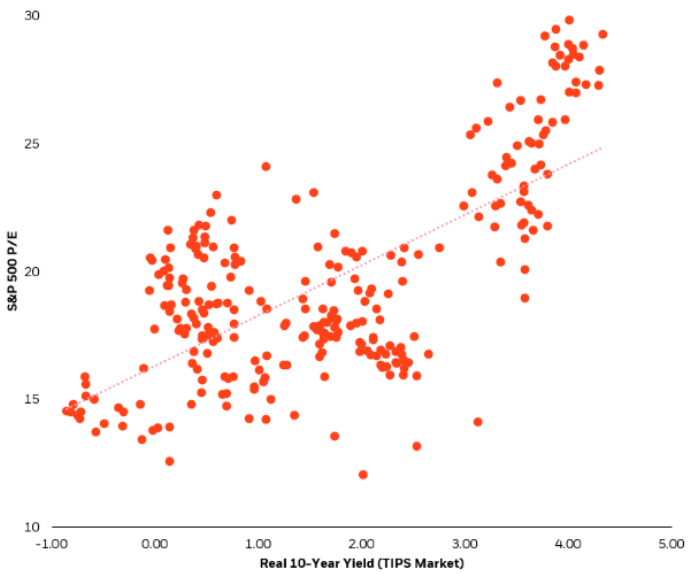
A complicated relationship

It is true that there have been historical periods, notably the '70s and early '80s, when higher rates coincided with lower valuations and poor returns. That said, the relationship between rates and stocks changes when rates are very low. At current levels the relationship between interest rates and valuations has been more ambiguous. At least historically, stock valuations have been more likely to rise than fall when rates are rising from low levels, as is the case today.

This tendency can also be seen when comparing changes in rates to changes in stock prices. Since 1995, in months when the U.S. 10-year treasury yield rose by more than 50 basis points (bps), over the following three months the S&P 500 posted a price gain of 3.2%, roughly 100 bps higher than a typical month.

The case for stocks and rates moving together is even stronger when comparing valuations to real interest rates, i.e. rates minus inflation expectations. Looking at data since the inception of the TIPS market, real rates and equity multiples typically have a strong positive relationship (see Chart 1). In other words, higher real rates have been associated with higher multiples. Based on this relationship you would expect a 50 bps rise in real rates to be associated with equity multiples moving up by one point. While real life is unlikely to conform exactly to the model, the relationship illustrates that real rates and multiples generally move together.

U.S. Real 10-Year Yields and Equity Valuations 1997 to 2020



Source: Bloomberg, as of 31/12/2020

Rotate yes, exit no

None of the above suggests that investors will hold their current portfolios. A change in the rate environment does lead to changing sector and style preferences. Defensive names, often owned for their dividends, suffer as rates rise. This rotation is already well under way, with staples and utilities the worst performing sectors year-to-date. Conversely, sectors such as banks, industrials and semiconductors tend to outperform as rising rates go together with an improving economy. The bottom line for investors is that while rising rates will favor certain market segments over others, most often rates and stock prices rise together.

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