Wayne Whaley Market Commentary/Studies

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THE PROSPECT FOR EQUITIES IN A 'RATES RISING FROM ZERO' ENVIRONMENT

Unless the February employment number, to be released on Friday, March 10th, blindsides expectations, it is highly anticipated that the Federal Reserve will raise the target for the Fed Funds rate (the rate banks charge each other in overnight lending) to 0.75-1% at their March 15th FOMC meeting, the third rate hike since the initial hike of this rate cycle in December of 2015. Trading in Fed Fund rate futures suggest, if the rate hike doesn't occur in March, the expectation is it will occur at the following FOMC meeting in early May.

Contrary to popular perception, you don't necessarily have to run out and refinance your mortgage or sell your bond fund as the thirty year bond rate is currently 3.05% about where it resided in December of 2015 when the Fed Funds Rate rising cycle began. Bonds Yields are not determined by the big guy, but are driven by market forces relative to inflation expectations. Bond Ylds historically average 1% above day rates, but has on occasion inverted, a story for another day, or I should say, another decade. It is not out of the realm of possibility that short rates could rise a bit more before long rates make a decidedly pointed effort to join in.

The general rule of thumb in equity investing is that it is not considered frugal to 'Fight the Fed', and there is a lot to be said for that thesis. Naturally, one has to respect the idea that higher rates provide more competition for equities in the traditional equity/bond portfolio, and vice versa when rates are low. I have spent a great deal of time trying to develop 'equity exposure vs interest rate direction' models and I learned several lessons in the process. Primarily that a 'Rates High and Rising' environment is traditionally very equity unfriendly (fall of 1987). However, rates 'Low and Rising' aren't as reliably equity unfriendly, and one can even make a strong case that rates 'Low and Rising' are initially actually very good for equities. My studies suggest that the correlation between the direction of rates and equities flips at some point, contingent on the level of rates.

Famed technician Edson Gould came up with the axiom many a decade ago, of 'Three Steps and a Stumble', which is widely quoted by technicians and suggest you should sell equities after three straight rate hikes. Tis important to note, the reason it wasn't 'One or Two' Steps and a Stumble, is because not only is the first rate hike not usually Bearish for equities, it's actually normally Bullish, as customarily you are coming from a low interest rate environment, whose yields do not provide much competition for equities and the economy is now coming out of a recessionary environment in which there is enough perceived growth to warrant raising rates. And if the economy is starting to grow, so shall company earnings, which should more than offset the enhanced attractiveness, interest bearing securities provide to equities after the first couple of initial rate hikes.

If rates are going from 5% to 6%, one could make the case, there is enough guaranteed return to warrant taking some equity exposure off the table, but if rates are going from 0 to 1%, it is more difficult to sell growing earnings for a guaranteed return of only 1%. My research led me to believe that Gould's axiom should be a little more dynamic, something in the lines of 'If rates are very high (>7%) one step and stumble, if rates are high (5-7%) two steps and a stumble, if rates are moderate (3-5%) three steps and a stumble, if rates are low (1-3%) four steps and a stumble, and if rates are less than 1% and moving higher, 'grab on and hold tight'.

Much of the problem, quantitative analyst have with coming up with simple interest rate axioms which apply today is that we are coming from an unprecedented zero rate interest rate environment and many of the trading rules developed over the last 50 years were developed across the inflationary databases of the 20th century. I have Tbill data going back to 1950 and the only time period in the last 67 years which remotely looks monetarily anything like today, is the 1950s, a decade, in which rates rose from 1.07% to 4.40%. You will see below, that during that decade, the S&P rose 250%. In fact, the only two down years for equities during the 1950s were 1953 and 1957, years in which rates actually dropped.

THE S&P AND TBILL RATEs - 1950s		
End of	TBILL%	S&P500
1949	1.07	16.76
1950	1.34	20.43
1951	1.59	23.77
1952	1.97	26.57
1953	1.20	24.81
1954	1.02	35.98
1955	2.50	45.48
1956	3.22	46.67
1957	2.75	39.99
1958	2.68	55.21
1959	4.40	59.89

When I put out the first version of this study two years ago, I summarized my comments by noting that my instincts were the first couple of rate hikes will be met with initial shortterm, knee jerk selloffs in equities, which should reverse and over the intermediate term, work higher. So far, that is playing out well. The Equity Bears, and anyone who I tend to irritate, will point out that the 1950's rally was possibly an aberration resulting from a decade of pentup equity buying supply resulting from the decade long second World Was.

I have attempted to put together an interest rate model for equities which will work over any interest rate regime. As I alluded, the problem is that the 'Equities to Interest Rate Direction' relationship is dynamic depending on the level of rates and most of the models end up being too complicated to be of practical use to most of us, and I always tended to fall back to pattern recognition techniques. But I did enough work on the subject to have a good idea where that research was headed and if you forced me to post a simple axiom on the subject today, a very simple rule that would be easy to remember would be something akin to a 'Rule of Five' and goes something like this, *'When the five year bond yield is trending toward five percent, you want to be overweight' equities and when the five year rate is trending away from 5 percent, you should be underweighted equities.* I need to make a bit of room on my plate for completing that research before one of you, choose to do so. The current Five Year Bond Yield rate is 2.07%.

My inclination is that current market momentum, in conjunction with a lovely Turn of the Year, tends to support the thesis that one should not let rising rates from the current low levels, flush them out of participation in the 'Equity Over Weighted' contingency: At least not in early spring. Stay tuned.