PERSPECTIVES

MAY 2015

The outlook for US equities and US interest rates

The dominant concern affecting US and global financial markets is the outlook for US interest rates. In this Perspective, we examine whether concern over rates is justified, what the timing and path of rate rises could be and what history tells us about the impact on US equities.

We make the case that interest rates are likely to stay 'lower for longer' consistent with the recent trend for rate-rise expectations to be repeatedly pushed out. We also argue that rate rises, when they do occur, will be measured and unlikely to derail the US bull market.

AT A GLANCE

- Investors are concerned about the impact of a rise in US interest rates.
- Yet, rate rises are only being considered because the US economy is in a sustained recovery.
- The Federal Reserve has reduced its trajectory for rate rises and lowered its terminal rate estimates, confirming a 'measured and gradual' approach.
- On current projections, the policy rate will only hit the 2% level in 2017.
- The 'savings glut' and 'secular stagnation' hypotheses argue that global excess capital is putting downward pressure on yields in a low-growth environment. Proponents expect fewer rate rises and lower peaks in real rates.
- For investors, the key recognition that rates are likely to stay '**lower for longer'** matters more than the precise timing of the first rate rise.
- Even when a rate rise does occur, history suggests it should not be a lasting problem for US stocks.
- While volatility typically picks up in the near term, in each of the last four rate tightening cycles, US equities were higher one year later.
- A first rate rise from historic lows is unlikely to derail the bull market in US stocks.

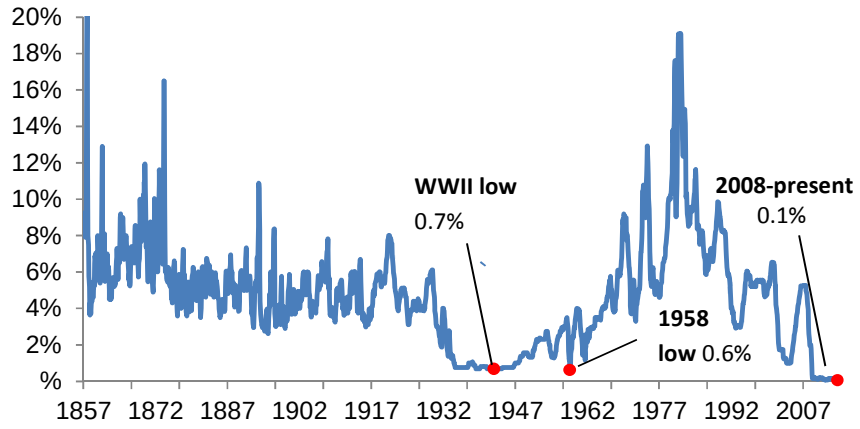
FROM CRISIS TO NORMALISATION

Post-financial crisis, the US Federal Funds Rate (FFR) was slashed from over 5% in mid-2007 to virtually zero (0.0-0.25%) by the end of 2008. As Chart 1 shows, US policy rates have since remained at this unprecedented low level.

The US Federal Reserve launched successive quantitative easing (QE) programmes in December 2008, November 2010 and September 2012 respectively. With the FFR already at the 'lower bound', the rationale for these QE programmes was to stimulate economic activity and support asset prices by expanding the Fed's balance sheet and putting downward pressure on US government bond yields.

As a result of the combined stimulus of record low rates and QE, the US economy finally embarked on a sustained economic recovery from 2013. This enabled the Federal Reserve to start 'normalising' monetary policy by 'tapering' its QE programme from January 2014. With tapering fully concluded by October 2014, market attention has focused increasingly on the likely timing of the first US policy rate hike.

Chart 1. US policy interest rates - long term perspective



Source: 1955-2014 period - US Federal Reserve (for Federal Funds Rate); 1857-1954 period- US National Bureau of Economic Research (using Commercial paper rate as proxy), April 2015

IS THE MONETARY BACKDROP A CONCERN FOR EQUITY INVESTORS?

The outlook for interest rates matters for US equity investors for a variety of reasons. Higher policy rates translate into higher bond yields and higher borrowing costs, implying a less favourable credit environment. From an equity valuation perspective, higher policy rates and Treasury yields tend to imply both a higher 'risk-free rate' and a higher discount rate applied to future cash flows. In terms of the discounted cash flow (DCF) models used to value stocks, there are therefore two countervailing effects for equity investors to consider as policy interest rates rise – the ability of the company to generate earnings in a recovering economy and the discount rate applied to those

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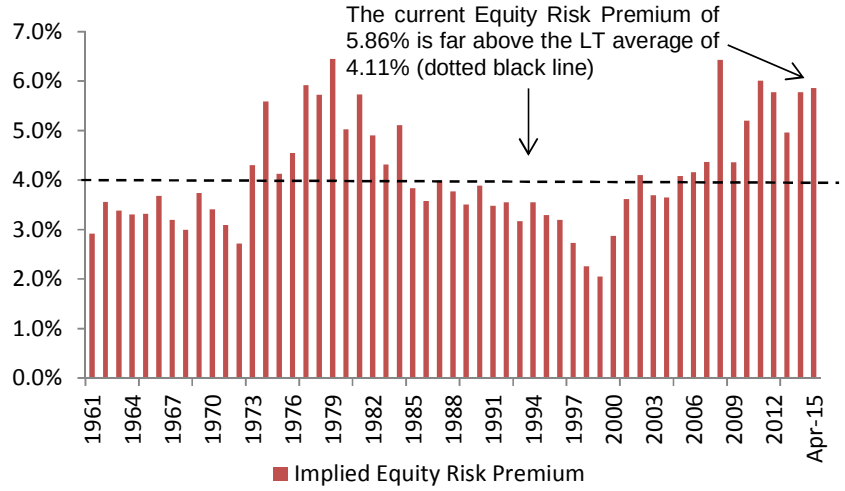
earnings. For example, future corporate earnings can be discounted using weighted average cost of capital (WACC), which is the average cost of equity and debt finance to a firm in proportion to their use. An increase in WACC entails an increase in the risk of investing in equity to achieve an expected return. However, equity analysts are currently using historically-low WACCs of around 8% for US stocks, yet WACCs may only rise moderately in the near term under a 'lower for longer' interest rate outlook, where excess capital continues to press down yields generally.

Investors have historically demanded an excess return, or equity risk premium (ERP) for holding US stocks versus the risk-free rate of US Treasuries. The implied equity risk premium that investors expect from US stocks is currently estimated to be around 5.7% over the risk free rate (see chart 2). This is well above the long term average level of around 4% (1961-2015) so even if the risk free rate rises, this suggests there is scope for further equity market gains if the ERP falls back to average levels.[1]

Chart 2. Implied Equity Risk Premium



Source: Aswath Damoradan, Stern Business School, New York University, April 2015.

ARE CONCERNS JUSTIFIED? IS THERE A 1930s PARALLEL?

The biggest concern over US interest rates is the risk of 'policy error'. As pointed out by hedge fund investor, Ray Dalio, the current US monetary policy backdrop has some parallels with the 1930s. In particular, then as now, the Federal Reserve responded to a credit-fuelled economic bust by cutting interest rates to zero and undertaking QE. With the economy seemingly recovering from 1933-36, the Fed began raising rates. However, in hindsight, this was too soon, because the recovery was more fragile than thought. The resulting decline in liquidity caused a further collapse in asset prices, causing the Fed to reverse course in 1937-38.

CURRENT RATE EXPECTATIONS

Fortunately, the governors of the Federal Reserve know the history of the Great Depression very well (former Fed Chairman Ben Bernanke wrote a book on the subject[2]) and are acutely alert to the risk of premature hiking. Despite the ongoing US economic recovery it seems assured that the Fed will take a measured and gradual approach to normalising rates rather than risk a repeat of the policy errors of the 1930s. Indeed, while market expectations have fluctuated considerably, the Fed has repeatedly surprised on the 'dovish side' by pushing out the timescale for tightening and repeatedly emphasising that any rate rises will be gradual.

The Fed will only raise rates when it sees a level of unemployment and output consistent with a positive level of inflation – a level called the Non-Accelerating Inflation Rate of Unemployment (NAIRU). Yet with unemployment at 5.5% without any evident pick-up in inflation and a disinflationary drop in the oil price, the Fed has adjusted down its own estimated range for the natural long-run rate of unemployment. So, the upshot is that the rate rises continue to be pushed out as even pre-established data targets are re-adjusted.

"Concerns about US equity valuations are misplaced. US stocks benefit from superior returns on equity; analysts are currently discounting US corporate earnings at WACCs of around 8% and I doubt they will be using WACCs in excess of 12% in 3-4 years' time via higher interest rates, given excess capital will continue to put downward pressure on yields. Indeed, I believe the case for a re-valuation of equities is still in front of us and multiples generally will continue to rise since nominal and real interest rates will remain unusually low, and savings will flow towards the assets with the most attractive real yields. "

Dominic Rossi, CIO Equities

Recent Fed meetings in March and April have been consistent with this pattern. The March Fed meeting was important because it also provided a summary of the Fed's latest economic projections, including FOMC members' expectations for rates going forward. Crucially, these projections suggest a much flatter trajectory for rate hikes than before. As summarised in Chart 3, key changes announced in the March FOMC meeting included:

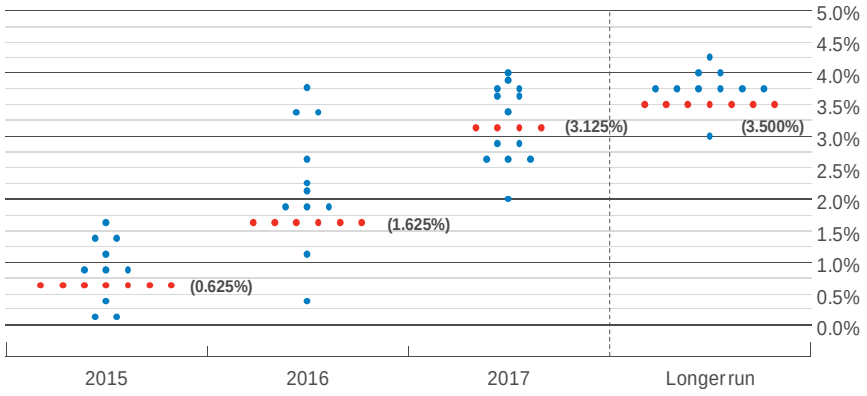
- A 50 bps downward shift in the median FOMC members' expectation for the FFR at the end of 2015 to 0.625% - assuming 25bp rises, this makes **September 2015** a more likely time for a first rise than June 2015.
- A 75bps downward shift in the median FOMC members' expectation for the FFR at the end of 2016 to 1.875% - implying rates will only hit the **2.0% mark in 2017**.
- A downward revision to the long run unemployment rate projection to a range of 5.0-5.2% from 5.2-5.5%, implying **more slack in the economy**.

"Based on recent weak US data, including a Q1 GDP print of 0.2%, we are minded to think the first rate rise might not happen till 2016 now, as the Fed is signalling strongly to the market they will be data-driven.

In any case, much of the rate rise is already priced into government bond markets and I don't think it will be a disorderly move when it happens, unless inflation is perceived to be a problem. There is less risk of a surprise this time as the Federal Reserve is at pains to avoid another taper tantrum."

David Buckle, Head of Quantitative Research

Chart 3. FOMC members' Federal Funds Rate year-end projections

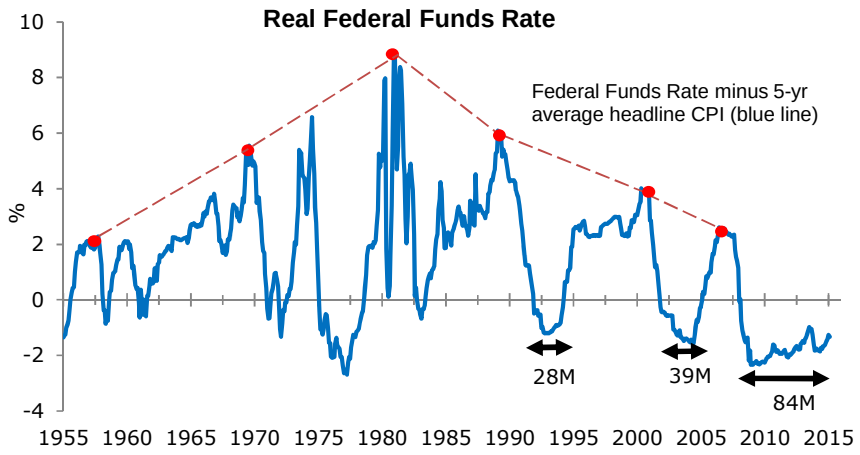


Source: US Federal Reserve, 18 March 2015. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the Federal Funds Rate or the appropriate target level for this at the end of the specified calendar year or over the longer run

THE LONGER RUN - WHEN MIGHT RATE HIKES BE CONCLUDED?

From the long-term equity investor perspective, what matters much more than the precise timing of the first policy rate increase is the speed with which rates will rise and where they will finally settle at the end of the tightening cycle. In terms of speed, it is apparent that the Fed is committed to a more cautious, smoother trajectory. However, it is also notable that its estimates for the long-run steady rate, or 'terminal rate', have been coming down from 4% in mid-2014 to 3.5% most recently. In addition to this, there is the pattern of the last 45 years to consider as depicted in Chart 4. This shows that policy rate trough periods have been becoming longer and rate-hiking episodes have been concluded at successively lower peak levels in real terms.

Chart 4. Successively lower peaks for the real Fed Fund Rate



Source: Federal Reserve, BLS, NBER, Minack Advisors. April 2015

"The Fed has so far been appropriately pragmatic in its decision making, and has tried to manage market participants' expectations as carefully as possible. A widely anticipated rate hike has been well flagged, and therefore shouldn't come as a shock to the market. If anything, I believe that the rate hike will take place later rather than sooner."

Angel Agudo, Portfolio Manager, US Equities

THE 'SAVINGS GLUT' HYPOTHESIS

In addition to the empirical evidence of lower real peaks in rates, an influential theory has gained steady support in recent years which argues for lower rates more generally. Renowned economic commentators such as Larry Summers, Paul Krugman and Martin Wolf have all argued that there is a persistent deficiency in aggregate demand due to an excess of global capital, or a so-called 'savings glut'. The consequences of this savings glut, which is forecast to get worse not better according to the capital/income projections of Thomas Piketty,[3] are likely to be both lower inflation and lower real rates versus history.

"In a world of excess savings, too much capital will chase too little income. Valuations for all asset classes will typically tend to move higher over time and remain defiantly high for longer periods, and there will be a greater propensity for asset price bubbles. Historical comparisons and valuation 'norms' become much less helpful in valuing assets."

Dominic Rossi, CIO Equities

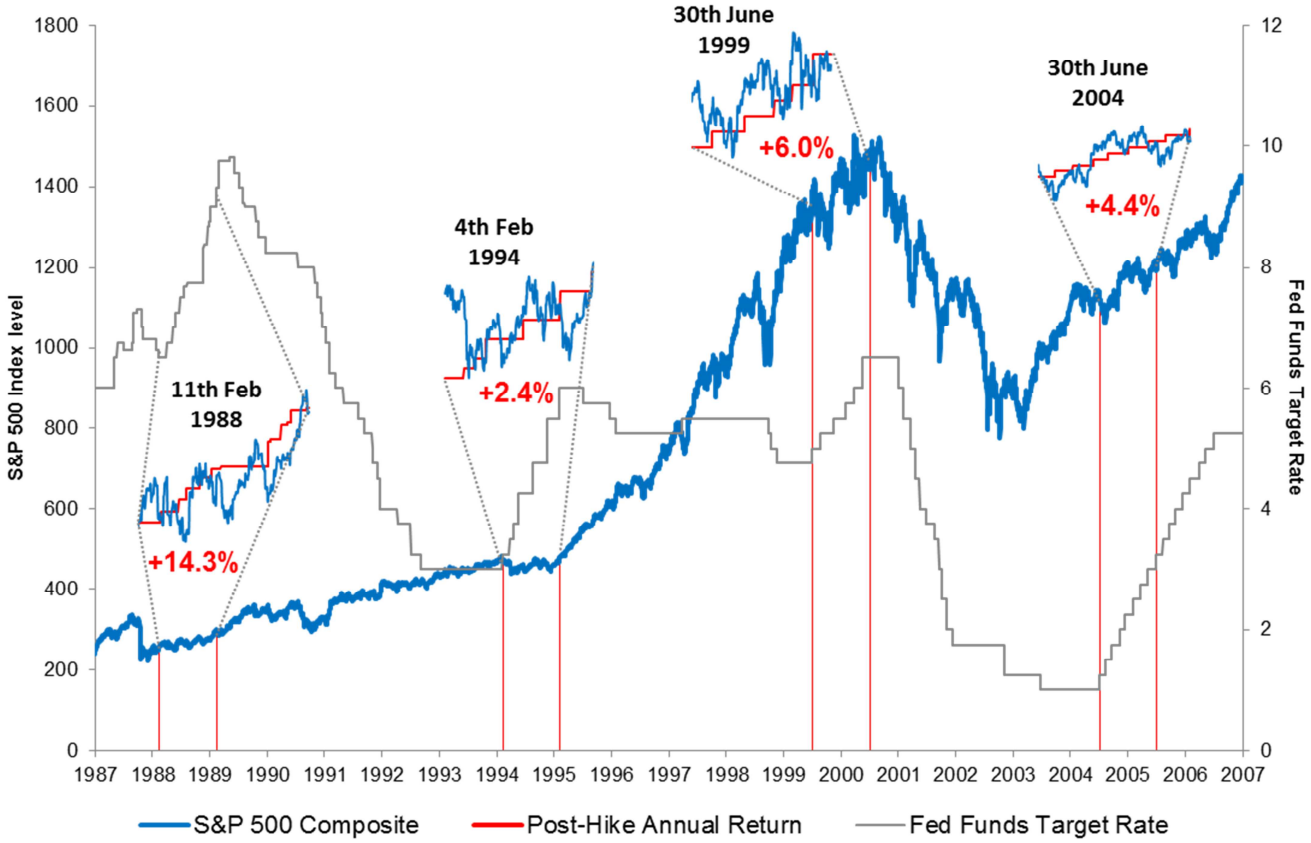
WHAT DOES THE PAST MARKET EVIDENCE TELL US?

The empirical evidence regarding the equity market impact from previous US rate hike scenarios is generally favourable.

- In the one year leading up to the first rate hike, US equities have risen appreciably on each of the last four occasions, with an average rise of 17%.
- In the period soon after the first rate hike, volatility typically spikes and corrections are possible.
- As Chart 5 shows, in the ***one year after*** the first rate hike, returns were positive in all of the last four instances with an average rise of 6.8% in these periods.

The good performance of equities in the one year leading up to and one year following the first rate hike is consistent with typically robust economic growth in these periods averaging 4.3% and 4.2% respectively for the four past hiking episodes.[4]

Chart 5. One-year S&P 500 performance after first US rate rise



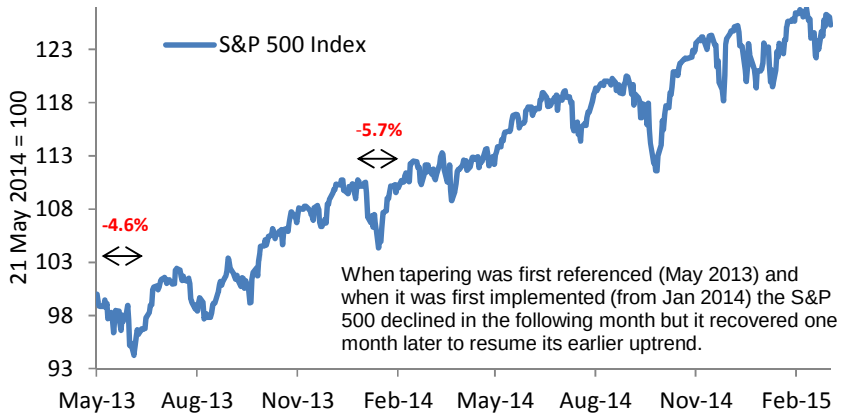
Source: Fidelity Worldwide Investment, April 2015

LESSONS FROM TAPERING

While the debate surrounding the first rate rise is attracting a lot of interest, it is worth remembering that the Fed has already been 'normalising' monetary conditions for some time through its 'Tapering' policy of slowing bond purchases between January 2014 and October 2014. The market reaction to the tapering phase could therefore be instructive.

As Chart 6 below shows, when the then Fed Chairman Ben Bernanke on 21 May 2013 first alluded to the possibility of tapering the Fed's bond purchases, the near-term reaction was notably negative with the S&P 500 falling by around 5% in the subsequent month. However, these losses were more than fully erased in the course of the following month. A similar pattern was evident when the Fed actually initiated the tapering programme in January 2014. The S&P 500 fell by almost 6% in the month, only for these losses to be erased in the subsequent month with the longer-term upward trend resuming thereafter.

Chart 6. Market impact of 'Tapering'



Source: Datastream, April 2015

CONCLUSION

After an unprecedented period of virtually zero interest rates, investors are understandably anxious about the possible negative equity market impact of rising US policy rates.

However, it is worth remembering that rate rises are on the horizon only because the US economic recovery is judged to be sufficiently robust. In addition, what matters much more from the real economy and long term investor perspective is not the precise date of the first small rate hike from a historic low base, but the likely trajectory and end-point of rates.

In this respect, wary of the mistakes of the 1930s, all the signs suggest the Fed will continue to be accommodative, with a very gradualist approach to rate rises and a significantly lower terminal rate compared to past cycles. Based on the Fed's own latest projections, the Federal Funds Rate will not reach the 2.0% level until 2017. Yet, this is a projection and it is worth noting the recent trend for Fed-influenced rate-rise expectations to be repeatedly pushed out. The influential savings-glut hypothesis provides a persuasive rationale for a more persistent situation of historically low real and nominal interest rates.

Finally, whenever rates do rise, past experience shows that US equities tend to rise significantly ahead of the first rate rise – and although volatility picks up immediately after the first hike – the US stock market was materially higher one year after the first rate hike in each of the last four hiking episodes.

"Nervousness over the first Fed rate rise is a classic short-term market response. Looking at the past four rate-hiking cycles, the market was up in the 12 months following the first rate hike each time, with an average rise of almost 7%. This US equity bull market still has some distance to travel."

Dominic Rossi, CIO Equities

REFERENCES

1. Aswath Damoradan, Stern Business School, New York University, damoradanonline.com

2. '*Essays on the Great Depression'* - Ben Bernanke, 2004

3. '*Capital in the Twenty First Century'* - Thomas Piketty, Harvard University Press, 2014.

4. Real GDP growth figures quoted are averages of annualised quarterly rates. The one-year ahead average figure includes the quarter in which the first rate hike took place. The one-year post figure refers to the four quarters following the quarter in which the first rate hike took place.

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