Rising Rates and Asset Class Performance

Our current equity bull market began in Spring 2009 and has run for 9 years - the second longest in history. However, the gains have been more muted than in some other bull markets possibly due to the nature of the economic crash in 2007-2009. Market recoveries after financial crashes generally take longer. The well-researched book *'This Time is Different'* by economists Carmen Reinhart and Kenneth Rogoff showed that it took up to 8 years for full recovery from previous financial crashes. We are now at that point and evidence is building that the USA has dealt effectively with many of the problems in its banks. The UK has also. Other European countries have made a slower job of rectifying their banks and that hangs over markets. But overall, markets have showed more exuberance over the past 24 months, following the sharp 'correction' in early 2016 and minor correction in early 2018. The USA has started to 'normalise'. It started raising interest rates in December 2015, triggering the market falls in early 2016, even though the rate rises signaled a strengthening economy. The UK would probably have done so too, but the Brexit vote led to a counter-trend lowering in rates in summer 2016 despite good economic performance. Nevertheless, globally we are probably in a phase of rising rates now.

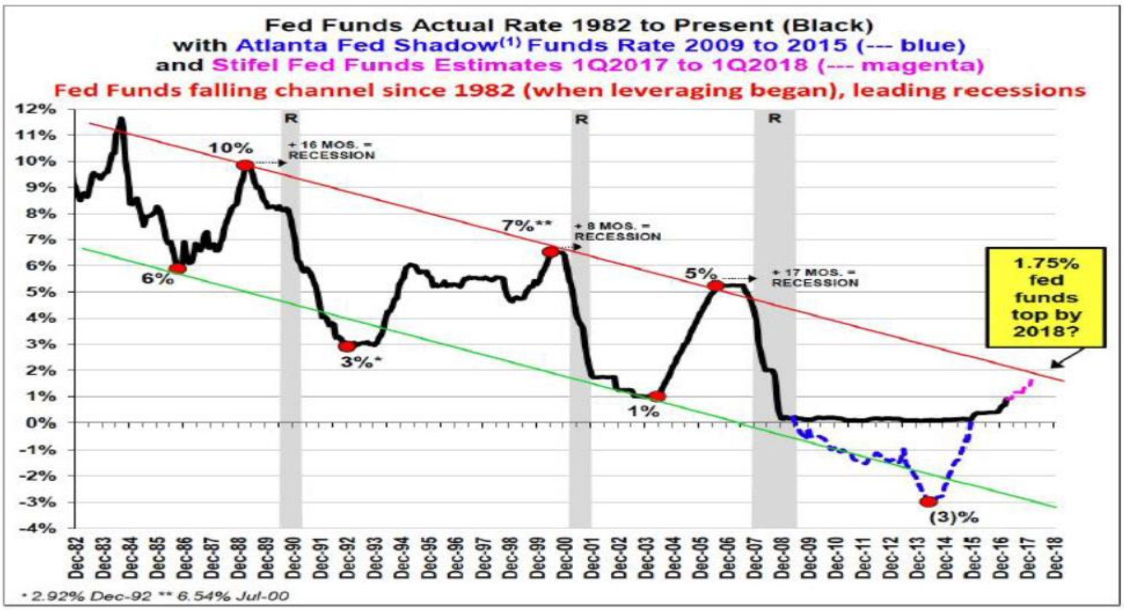
The key questions for investors are:

- Which asset classes do best as rates rise?
- How long can the bull market last as rates rise?
- What could cause the bull market to end?

We must consider that 'this time is different' from rate rise cycles in previous decades, since the 1980s at least. I used the word 'normalise' above because rates were taken to extraordinarily low levels, unprecedented in Bank of England records going back several centuries. In the USA, the Federal Reserve is not so much raising rates to cool an over-heating economy as trying to get rates back up to average levels - so it has some ammunition, if required, to fend off a slowdown by lowering rates again. When rates are at one quarter or one-half percent, central banks are stymied. The UK remains in that position so any slowdown here will leave the BoE in a fix. At present, the lower pound is helping the economy and it seems likely that the pound will be the adjuster for some time to come. It may be more volatile than normal.

How high can rates in the USA rise before having a negative impact on the economy? This is a key question. Maybe not so high as in previous decades. The chart below, from the Swiss company Stifel, is worth studying carefully.

The grey vertical lines are recessions in the USA since 1982, each of which was preceded by rising rates, intended to cool an over-heating economy and inflation. Note how the red line maps the peak rate achieved before recession occurred. The line is sloping downwards because the peak rate ahead of each recession got lower. A projection of the line suggests that a short-term interest rate of only 1.75% or 2% could be enough to strangle growth and stock markets. These USA figures are relevant because other countries tend to follow what happens in the world's largest economy.



An important fact to know is that central banks control only the short-term rates, such as the Fed Funds Rate in the USA and the Bank Base Rate in the UK. They do not directly control the 2-year and 10-year bond yields, which are determinants of the yield curve, one of the key measures that can herald a coming recession and bear market. Shorter duration bonds may be affected by short term rates more than long term bonds, so the two-year bond yield may be influenced to some extent but not usually the ten-year. The longer-term bonds are governed by investor perceptions of economic growth and inflation. If economic prospects appear to dim, ten-year bond yields could fall at the same time as Central Banks are pushing up short-term rates. That could lead to inversion of the yield curve, making it negative as it is calculated by subtracting the two-year rate from the ten-year rate. It could end this bull market if central bankers misread the situation. They always have got it wrong at some point! Today, the yield curve remains positive but only just so, as Eoin has highlighted. Note that market peaks in the past have sometimes been coincident with inversion of the yield curve, but more often the peak has come some months, even up to 2 years, after the initial inversion. Note also that the yield curve can revert back to positive territory about the time the market peaks, so do not be misled!

So, the bull market looks likely to continue for a while yet, though with rising short term rates and a rapidly falling yield curve, we have probably entered the final phase of this cyclical bull market. Before worrying about the words ‘final phase’ it is worth reflecting that the final phase of bull markets is often the strongest. This has been a very unloved bull market with many commentators predicting another crash and mis-advising their subscribers who presumably missed most of the gains. It troubles me that some of those misguided commentators have now turned more bullish! However, we have not yet seen the euphoria that often accompanies the final rise of markets, driven by the public returning to purchase shares. Indeed, pessimism abounds.

Which types of share have done best historically as rates rise? Financial services generally suffered from low rates and they should now be benefiting in countries where rates are stabilising or rising. This includes banks, brokerage services and asset management companies, and insurance companies that have high cash flow and earn higher income from higher rates. Travel companies can do well as the feel-good factor returns and the consumer discretionary sector in general is a winner. Technology large caps may do well due to increased spending on their offerings and higher earned interest on their large cash piles.

Which shares do not so well? Slow growing businesses go out of favour as economies expand. Businesses that need to borrow a lot of money to operate have higher interest payments to make. These include utilities, telecoms and loan-dependent companies such as car manufacturers and builders. Emerging markets have often benefited from expansion in developed countries due to increased exports of goods and commodities. However, a strengthening dollar can impact emerging markets governments and corporations as their dollar-based debts cost more in interest payments.

Commodities have often benefited from market expansions and look likely to do so again, though one may need to be selective. Economic expansion may be accompanied by rising fuel costs and rapid rises in oil prices have often driven inflation. This results in rate rises to control the inflation, with a squeeze on economies and markets. Oil prices have been manipulated for political reasons in the past, but this looks more difficult now that fracking in the US has become very economic and seems to be dampening any rise in oil prices. However, oil prices have risen quite substantially over the past 12-18 months and should be watched carefully.

Bonds are more nuanced. As they are considered a safe-haven, the return of animal spirits is generally not to their benefit. In addition, bond yields are at historically low levels i.e. prices are at historically high levels and looking vulnerable to rising rates. Bonds with higher coupons (interest payments) are protected to some extent from capital losses but coupons generally are quite low compared to previous rate rise cycles. The impact of rising rates on bonds can depend on several factors, such as the level from which rates start to rise, the coupon of the bond, the duration of the bond, how much rates rise, and how fast they rise. We need to be very careful to avoid capital loss on bonds. The table below shows the steep losses that could accrue for instance on government bonds for each one percent rise in interest rates, depending on the duration of the bond.

Change in bond price for each 1% change in interest rates

Yield/coupon	30-year bond	10-year bond	5-year bond
5%	~15%	<8%	4.4%
4%	~17%	~8%	4.5%
3%	~19.5%	~8.5%	4.6%
2%	~22%	~9%	4.7%
1%	~24%	>9%	4.7%

Of course, it works in both directions. Big gains can be made from longer duration bonds if rates fall. History shows that high yield short duration bonds, particularly corporate bonds, have fared best during previous rate rise cycles. High yield corporate bonds have the lowest correlation with government bonds.

Precious metals such as gold and silver are difficult to call as their price generally depends on government and central bank actions. Gold often benefits when real rates (after inflation) are negative. If the rate of inflation rises faster than yields on bonds or shares, or yields decline below the rate of inflation, then gold can do well as demand increases. Essentially, rising inflation or fears of deflation are the best catalysts for gold price, while disinflation (falling inflation amid growth) is negative for precious metals. At present, the direction is not clear.

Property has been a great winner in previous rate rise cycles. Rises in mortgage interest payments have not deterred home buyers. House prices have given double digit gains during the final phase of economic expansion. The housing cycle is not always in sync with the business cycle. It seems to follow its own 18-year cycle, with about 12-14 years of price gains, then several years of falling or flat prices. UK records show this pattern going back several hundred years. It is evident in the USA too. The last peak in prices was in 2007 in the USA and 2008 in the UK, which suggests the next peak is likely in the mid-2020s. A mid-cycle slowdown evident in the historical data is due soon, and one can easily imagine the Brexit negotiations and actual exit being a catalyst this time. The mid-cycle slowdown has in the past been followed by a strong recovery. The final phase of the housing cycle often sees the largest gains. Note that the peak and fall of the 18-year housing cycle has often coincided with or perhaps caused significant economic downturns and falls in stock markets such as 2008, 1990 and 1973. The mid-2020s remain a distant prospect for now!