Prognosticating the Effect of Higher Interest Rates

People often ask me how I think equity markets, including Master Limited Partnerships (MLPs), will perform when interest rates are rising. It’s a timely question, since bond yields have been moving higher for the past couple of months. The yield on the ten year U.S. treasury recently touched 2.5% as markets look ahead to a tightening by the Fed later this year. Of course, the Fed has been steadily pushing back the first rate hike, since it turns out they’re not any better at forecasting rates than the private sector, as I wrote a couple of months ago in Preparing for Higher Rates. Nonetheless, they will be right eventually and financial advisors would like to be prepared.

The relationship between interest rates and most asset classes is not simple. Bond prices mathematically fall with rising yields since their payouts are fixed, but equity securities whose return comes from both dividends and dividend growth have a more complicated relationship with rates.

Stronger economic activity can be expected to translate into faster profit growth and higher dividends, in which case higher rates represent confirmation of a more robust economy and need not be negative. Conversely, if rates rise while inflation is unchanged, it results in higher *real rates* (i.e. after inflation) and this in theory reduces the value of all assets.

But we know rates will rise, and the yield curve is pricing in the expectation of a higher Fed Funds rate in the next 6-12 months. So part of the question comes down to what the market will do if the market’s own forecast of the timing of rising rates turns out to be correct. In this respect, it boils down to a question of market psychology; if rates rise following the path already reflected in the yield curve, it ought not to surprise. In fact, the prices of treasury bonds ought not to change, in theory, since their prices already reflect that path. They obviously will move, but where will they, and equity markets, settle?

I have a friend who has an exceptionally acute sense of such things. Through seemingly logical analysis, he often arrives at an insight that sometimes seems so obvious but wasn't at all clear until he pointed it out. On this topic, he recently noted to me that if he was considering buying stocks but planned to sell upon a Fed rate hike later this year, he wouldn't invest. It seems so blindingly obvious, but if something unsurprising will happen that would cause you to sell, you would avoid putting yourself in that position.

Therefore, if you put yourself in the mind of this mythical yet rational investor; if this participant isn't going to sell stocks at that time, who is? And the answer is, people with a short term horizon who expect selling by others and wish to avoid a near-term drop in their portfolios, or hope to buy back shortly afterwards. And from whom exactly will they buy back their shares, if our mythical yet rational investor (perhaps with many like-minded folk) is not then a seller?

This is exactly the kind of set-up that can cause equity markets to reach higher prices than existed prior to the "news", as the participants expecting to buy from other more hasty investors find far fewer such impulsive folk exist than they might have expected. We don't forecast equity markets, but don't be shocked if stocks rally on the first rate hike.

The analysis of market psychology is of course an endless game that never ends. Events big and small are anticipated, happen and are reacted to along with big and small surprises too. As soon as the aftermath of one event reveals the true disposition of willing buyers and sellers through their subsequent actions, the build-up to another event begins. It's very hard to be good at figuring this out, and in my experience the supply of people with opinions far and away exceeds the number whose views result in profitable outcomes. But I know just a very few who have turned astute observation into market profitability.

For our part, while this type of prognostication can be fascinating, there isn’t a plausible move in interest rates that would cause us to sell investments which are, by definition, held for the long run. Several months at least lie between today and the resolution of that particular event. When it happens, if equity markets fall, we shall be among those whose portfolios suffer a loss in value. However, we shall not be a seller in response to something not surprising. Ben Graham is believed to have said that in the short run the market is a voting machine while in the long run it’s a weighing machine. We’ll weigh things up down the road.