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What Pivot to Higher Rates May Mean for Stocks

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Asset Allocation Insights

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KEY INSIGHTS

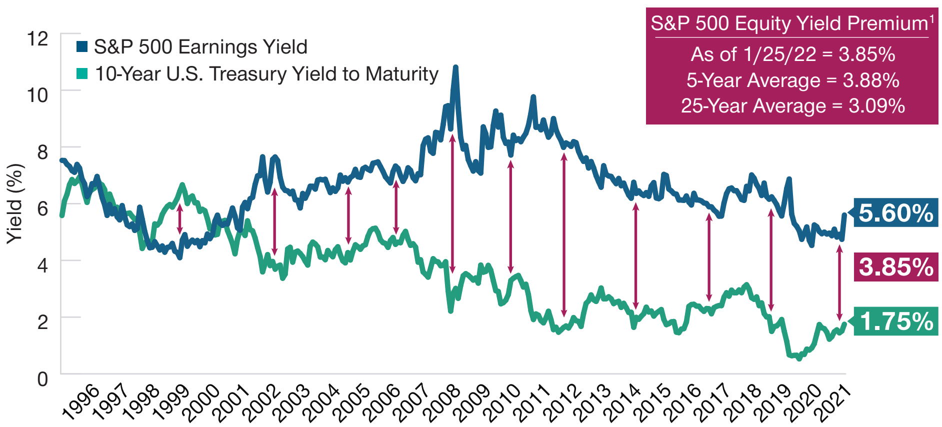
- Global equity markets sold off in the opening weeks of 2022 as investors weighed the potential impact of higher interest rates on their stock portfolios.
- In an effort to manage near-term risks, the Asset Allocation Committee currently is underweight equities, tilting away from areas vulnerable to rising rates.

After maintaining a dovish position for most of 2021, the U.S. Federal Reserve (Fed) recently pivoted to a notably hawkish stance. As a result, interest rates are on the rise, which, in part, has driven recent equity market volatility.

While the Fed is still in the very early stages of a hiking cycle, we believe a review of yield premiums across a range of past economic cycles could provide useful insights for investors concerned about the potential impact of higher rates on their portfolios.

Equity Yield Premium Averaged Higher in Last Five Years

(Fig. 1) Rising interest rates could bring lower equity yield premiums



Based on historical data for the 25 years ended January 25, 2022.
Past performance is not a reliable indicator of future performance.
[1] Equity yield premium = S&P 500 Index earnings yield (earnings/price) - Yield to maturity of U.S. 10-year Treasury note.
Sources: Bloomberg Finance L.P. and S&P (see Additional Disclosures).

By comparing the current yield to maturity of the 10-year U.S. Treasury note to the earnings yield on the S&P 500 Index—earnings per share divided by price—investors can measure the premium that equities have historically offered over bonds. While this premium was fairly consistent over the five years ended January 25, 2022, it varied widely over the last 25 years (Fig. 1) and was significantly lower prior to the 2008 global financial crisis.

The derived equity premium can be used to estimate the potential impact of higher interest rates on valuations and even on stock prices. For example, if interest rates were to move higher while the equity yield premium remained relatively unchanged—as it has over the past five years—our analysis suggests that stock prices could hypothetically fall further, even after the recent meaningful sell-off. However, if we assume a yield premium equal to the 25-year average, the impact of rate increases appears muted.

In our view, further interest rate increases could be a headwind for equities—at least over the near term—but the overall impact could be somewhat mitigated as investors adjust their equity yield premium expectations. In an effort to manage the near-term risks, our Asset Allocation Committee has an underweight tactical position in equities, tilting away from areas vulnerable to rising rates. Within equities, the committee currently is underweight growth and U.S. stocks relative to value and other global regions, respectively.

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