THE OMNIVEST MARKET VIEW

Investments

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A Bit of History may Calm Some Nerves

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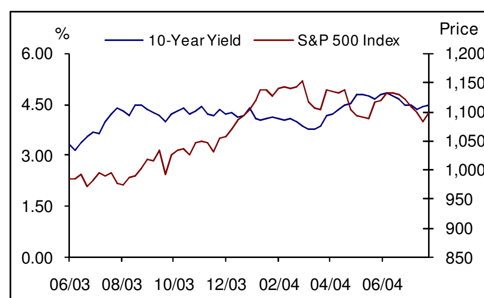
The most recent increase in Treasury yields since the start of March has sent shivers down the spines of "would be" equity investors. After all, aren't rising interest rates supposed to choke off economic activity? In theory, the answer is always yes. However, theory also needs to have a little help from context. For example, if market yields are rising in response to an increasingly favorable economic environment and from unsustainably low levels, then equity investors should temper investor fears.

Financial markets are supposed to be forward looking, such that a rise in Treasury yields would also indicate that the market is beginning to price in an inevitable tightening of monetary policy by the Federal Reserve by raising interest rates. Under the leadership of Alan Greenspan and Ben Bernanke, any shift in monetary policy has been well orchestrated in such a manner so as not to shock the financial markets. As a result, the markets have been well ahead of the Fed in anticipating changes in interest rates and the adoption of quantitative easing.

Many investors seem to have forgotten that when interest rates begin to normalize, the impact on the equity market and other risk assets have been quite favorable. The most recent example of the markets leading the Federal Reserve was from June 2003 to June 2004. During this period, the Fed cut the Federal Funds rate to 1% on June 25th 2003 and held steady until June 30th 2004.



Source: *Bloomberg*

This may sound surprising given the backdrop of the rate cut on June 25th 2003 even though the 10-year Treasury yield actually bottomed on June 13th 2003 at 3.11%. Interest rates rose to 4.35% by September 2003 and continued to rise to 4.69% up until the eve of the first rate hike by 25 basis points (bps) on June 30th 2004. What may have been driving market rates higher was the improving tone of the economy. Looking at Non-Farm payroll data (only) we find that the labor market shed 271,000 jobs in the three months leading up to the last rate cut in 2003. During the following twelve months leading up to the first rate hike, Non-farm payrolls added 1.6 million jobs. Clearly the economic environment had changed and the bond market was beginning to anticipate rate hikes.

At the same time the equity market was beginning to gain upward momentum and rallied 15% from the last rate cut until the first rate hike, even though 10-year yields rose by 153bps during the same period. A redux may be in the making.

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