Will Rising Interest Rates Hurt Stocks?

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When Federal Reserve Chair Janet Yellen said recently that the economy had grown strong enough for the Fed to raise interest rates, stocks jumped. Though they sagged later in the day, the reaction of the markets has clearly indicated comfort with the prospect of higher rates.

But why? Many experts have long claimed that low rates have been a chief factor in the seven-year bull market in stocks.

So, just what is the relationship between interest rates and stock prices?

"Simply put, stock market returns historically are ... much higher when interest rates are trending downward than when they are trending upward," says Robert R. Johnson, president and CEO of The American College of Financial Services in Bryn Mawr, Pennsylvania, and co-author of "Invest With the Fed," which explores the stock-interest rate relationship.

Johnson said he and his colleagues, Gerald Jensen of Creighton University and Luis Garcia-Feijoo of Florida Atlantic University, found that from 1966 through 2013, when interest rates were falling, the Standard & Poor's 500 index returned 15.2 percent compounded annually. But when rates were trending upward the return was only 5.9 percent.

Stocks are more attractive. One reason is that when rates are low, stocks' chief competitor for investor dollars, bonds, are less appealing to investors. When bond yields are stingy, investors are more willing to take on the risk of owning stocks.

"I believe that quantitative easing and expansive Fed monetary policy has been the biggest single driver in the bull market since the financial crisis," Johnson says. "The unprecedented low interest rates have essentially forced investors into equities, as the real returns on bonds (with inflation considered) are essentially zero or even perhaps negative."

Falling rates are actually good for investors who already own bonds, because they drive up prices for older bonds that pay more than new ones. That's why bonds have done so well in the past few decades. But investors are reluctant to put fresh money into bonds when yields are low.

Today, rates are at record lows and more likely to go up than down. That would reverse the incentives, making older, low-yielding bonds less appealing than newer, more generous ones after rates rise, and causing older bonds to fall in value. So many advisors are warning that bonds look risky today, making stocks look better by comparison. Longterm bonds are especially susceptible to rising rates because their owners are stuck with below-market yields for so long.

By the numbers. Math also explains whey stocks are strong when rates are low. In assessing stocks, many investors look at the price-earnings ratio, or the current stock price divided by earnings over the past 12 months. Today, the P/E on the S&P 500 is about 25.

Looked at the other way, as earnings divided by price, or earnings yield, earnings equal about 4 percent of share price. Investors buy stocks to share in earnings, or to enjoy price gains driven by rising earnings, and a 4 percent earnings yield is a lot better than the 1.6 percent yield on the 10-year Treasury note, or less than 1 percent in bank savings.

When prevailing rates are low, investors will accept a lower earnings yield on stocks, since the alternatives pay so poorly. If a 3 percent earnings yield were acceptable, that would translate to a P/E of 33. And if earnings stayed flat, share prices could rise by 32 percent to raise the P/E to 33 from today's 25. That's one reason share prices rise when interest rates fall, and fall when rates rise.

"All else equal, higher P/E ratios can be justified in a lower interest rate environment, as the present value of future earnings is worth more in a low interest rate environment than in a high-rate environment," Johnson says.

Debt is cheaper. In addition, low rates allow companies to borrow cheaply and to refinance debt, boosting profits and therefore share prices," says Michael E. Chadwick, of Chadwick Financial in Unionville, Connecticut.

He worries that easy money has stoked asset bubbles around the world, and that a day of reckoning is overdue.

"The rate increase will simply accelerate the process or perhaps be the piece of news that starts the process," he says.

So why isn't the prospect of rising rates jarring the markets today?

The Fed is cautious. For one thing, the Fed will raise rates only because it feels the economy and job market are strengthening, which should be good for corporate profits and share prices.

"Theoretically, a gradual increase in interest rates should help stocks," says Kurt M. Brown, co-chief investment officer at PDS Planning in Columbus, Ohio. "Rates typically rise due to a broad-based improvement in the economy. As the economy improves, wages also rise, which causes consumers to spend more of their discretionary income."

Of course, at some point rising rates would indeed alarm stock investors. Higher rates raise borrowing costs, hurting corporate earnings. And they make other investments more competitive. Most important, high rates usually coincide with rising inflation, which makes future earnings less valuable because a dollar will buy less, Johnson says.

But at this stage, most experts think rates will rise, if they do, very slowly. So many of the benefits of low rates will last for some time, while an improving economic outlook may help offset worries about the economy eventually overheating.

"We think rates (will) stay low," says Ben Stewart, founder of Stewart Wealth Management in San Rafael, California. "I can see the Fed funds rate staying under 1 percent for the next three years and under 2 percent over the next decade."

"Stock returns will likely be lower as the Fed begins to raise rates," Johnson says. "That doesn't mean, however, that stock prices will necessarily fall, just that returns in a rising rate environment tend to be lower than returns in a falling rate environment."

But the future is especially cloudy because the long low-rate period has been so unusual, Chadwick says.

"Our Fed raised rates last December for the first time in almost a decade and stocks wobbled for a bit, but they're now higher than ever and rates have officially gone up 0.25 (percent)," he says. "It's common for the second rate hike to be the kiss of death for stocks, so we'll see what the Fed says next month, and see what the reaction is."

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