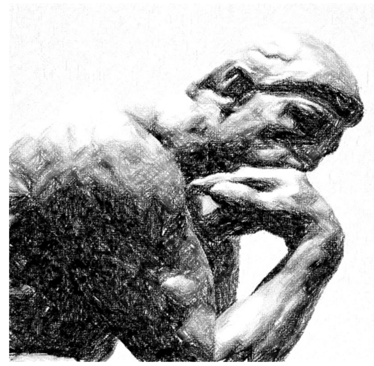
The Relationship between Interest Rates and the Equity Market

The Thinking Man's Approach



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- Equities in the U.S. have rallied significantly from the lows of March, led by mega cap tech companies that have benefited from low interest rates and the stay-at-home economy.
- This behavior has created an anomaly in the equity market, where the top five companies in the S&P 500 now account for just under 25% of the index, while the year to date performance of the average company remains negative.
- A sustained economic recovery could lead to an increase in interest rates, which might end up affecting the value of these top companies in the index, potentially dragging the entire market with them.
- Nonetheless, our base case scenario is that rates will remain at current levels for the near future. Hence, we maintain a constructive view on the equity market, but expect the rotation into cyclical stocks to continue to consolidate.
- We recommend clients build a "barbell" portfolio, with exposure to momentum-tech plays and cyclical stocks that benefit from an economic recovery.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

In this issue of the Thinking Man, we analyze the relationship between interest rates and the equity market in the U.S. After the Covid-19 bear market of the first quarter of 2020, the equity market in the U.S. has recovered 57% from the bottom of March 23. As of the end of August, all three major indices are in positive territory for 2020, with the NASDAQ and S&P 500 having also surpassed their previous all-time high reached on February 19. A few mega cap technological companies have led the impressive rally, which has produced an equity market with an extremely narrow breadth, last seen during the internet bubble of the late 1990s. Currently the top five stocks in the S&P 500 (AAPL, MSFT, AMZN, FB and GOOG) account for just under 25% of the total value of the index. These companies have benefited from the stay-at-home economy produced by the pandemic and from a collapse in interest rates globally.

This last point is particularly interesting, as equities used to have a significant correlation with interest rates. When the economy was booming, equities would rally and rates would increase (fixed income would lose value). On the other hand, when the economy was in recession, rates would fall (fixed income would appreciate) and equities would suffer. However, after two crises (Great Financial Crisis and Covid-19) and four rounds of Quantitative Easing (QE), this "market axiom" seems to have been broken. There are three main reasons why the equity market, especially growth technology stocks have benefited from the current low interest rate environment.

1. Growth stocks benefit from lower rates

In a low rate environment, growth companies can take advantage of favorable borrowing conditions to issue very long-term debt, and engage in additional projects that increase future earnings, revenue and value for the company. Some firms are even taking advantage of the low-rate environment to secure cheap debt over the long run. In fact, over the past several weeks, we have seen corporate issuance at historical low yields. For example, Google was able to issue debt of several maturities, at a historically low rate for a high-grade issuer.

Similarly, Ball Corporation, a company with a BB+ credit rating, was able to issue a 10-year bond with a spread of just 230 bps or a yield around 2.85%. This marks the first time in recent memory that a high yield company has issued debt at a yield below 3%.

2. Stocks are not as expensive as bonds

   Because of Covid-19 and QE, yields in fixed income instruments have fallen to historical lows. This is particularly true for sovereign and high-grade bonds, which have negative real returns. Similar to what happened over the last decade; investors looking for higher returns have been pushed to the high yield and equity market. In the latter, these mega-cap tech stocks are now seen as "safe-havens" as their business model actually thrives during the pandemic. Overall, the equity risk premium of the U.S. remains at around 5%, which is extremely attractive, compared to risk free rates such as U.S. Treasuries. Hence, as rates remain depressed, appetite for these companies should continue to increase.

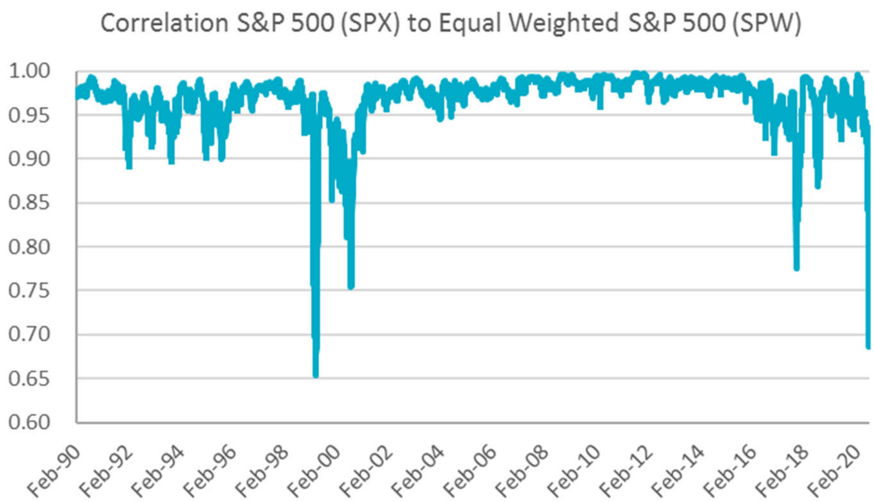
3. Lower discount rates increases the value of growth companies

   Finally, most of the value of growth companies is derived from expected revenues and earnings several years into the future. The fall in rates also reduces valuation discount rates, which significantly increases the Net Present Value of these future expected cash flows. For these companies, current earnings, which are highly uncertain due to Covid-19, are much less important than future earnings, where the pandemic should be under control and the economy should be back to normal. This also helps explain why current valuation metrics, such as price to earnings of 21x, could be adequate even as they might look expensive from a historical perspective.

The problem with the current rally, that has analysts and investors worried alike, is that almost exclusively these mega-cap tech stocks have driven it. As we mentioned previously, they have benefited from the current low rate and yield environment. The main problem lies in that even as the S&P 500 is currently at an all-time high, the average stock in the index is still down year to date, with significant losses in some of the economic sensitive industries. If rates were to increase, sentiment could quickly change towards these "high-flying" stocks, potentially bringing down the entire market.

Rates usually increase when the economy starts to recover from a recession driven by two complementary main forces. First, as the economy starts to recover, investors usually divest from safe havens such as treasury bonds and increase their exposure into risky investments, such as cyclical stocks, that should outperform with the improved economic outlook. As the economy stabilizes and growth resumes, the Federal Reserve (Fed) starts to preemptively raise reference rates in an effort to prevent an overheating of the economy, while controlling inflation. What makes the current bull market potentially fragile, is that it is extremely "top heavy", concentrated in a few names that have similar business models and that have benefited from low rates.

To expand on the previous point, it is worth looking at the correlation[1] between the capitalization-weighted index and the equal-weighted index, which can be seen in the chart below. In a market that is working correctly, the movement of both indices is very similar as they exhibit a high correlation, usually above 0.95. In other words, this means that all stocks are moving in tandem. On the other hand, when the market is not working correctly, the correlation between the two drops, as is currently the case, with the correlation falling to 0.69. This also occurred during the late stages of the 1998/99 internet bubble. Counterintuitively, the market could end-up reversing some of its recent gains, if the economy continues to recover and rates rebound higher.



Source: Bloomberg, Graph: BigSur Partners

However, even as we are in the middle of the economic turnaround, we believe that rates are likely to remain depressed for the near future. On the Jackson Hole Symposium, Fed Chairman Jerome Powell announced that the central bank would allow inflation to run moderately above the 2% target to compensate for periods where it has run below the objective. This means that a rate increase by the Fed does not appear in their plans over the next couple of years. In addition, because of QE and Covid-19 derived uncertainty, there is still significant appetite for risk-free assets, and this is not likely to change, at least in the short term. Hence, we remain constructive on the equity market, as we believe that the rally should continue, albeit at a slower pace, as investors continue to rotate into cyclically sensitive industries, sectors and companies.

With this in mind, our recommendation to clients is to have a "barbell strategy" with a portion of the portfolio invested in momentum-tech plays and another portion in cyclical stocks. The resulting portfolio would benefit from a continuation of the current rally in tech companies, but would also give exposure to companies that benefit from an improvement in economic perspectives. The cyclical sectors that we

[1] The correlation coefficient is a statistical measure of the strength of the relationship between the relative movements of two variables. The values range between -1.0 and 1.0. A correlation of -1.0 shows a perfect negative correlation, while a correlation of 1.0 shows a perfect positive correlation. A correlation of 0.0 shows no linear relationship between the movement of the two variables.

currently recommend include transportation, travel and leisure, construction, aerospace and defense, and retailers.

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