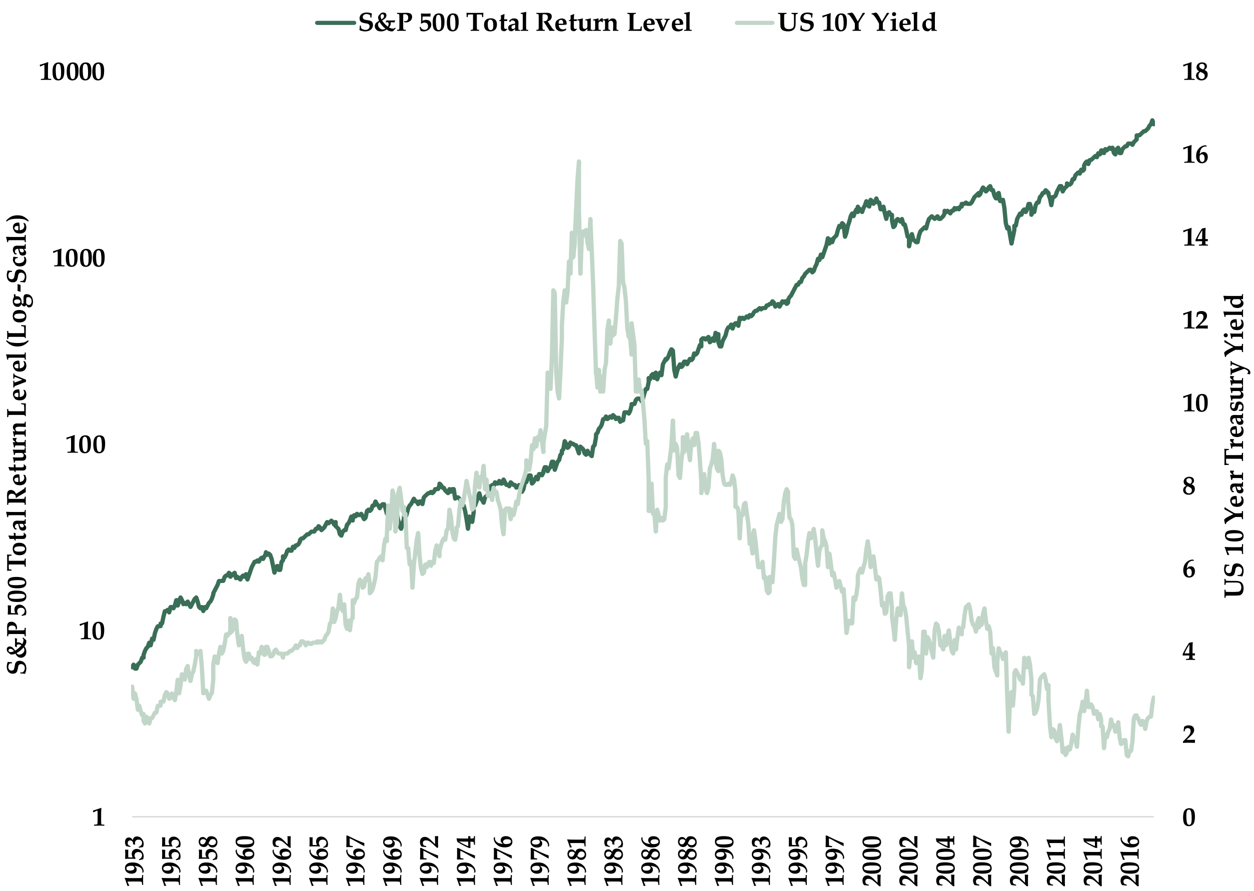
In our 2018 forecast, we explained our view that long-term interest rates should remain benign—not rise in lockstep with short-term rate hikes, as many assume they will. Investors thought rates would skyrocket last year, too, but after the Fed hiked three times, long rates ended the year lower. Long rates also didn't rise significantly in the last rate hike cycle (2004 – 2006). This is because hiking short-term rates flattens the yield curve, a headwind to bank profitability and lending. Less lending means slower money supply growth, lowering inflation expectations, which are strongly correlated with long-term rates. Therefore, one shouldn't predict higher long rates ahead merely because short rates rose in the recent past. This misperception stirred fears rising long-rates would hurt equities early this year, but even if we are wrong and rates do rise, equities needn't suffer. Historically, changes in long rates—as measured by 10-year US Treasury yields—have provided little insight into equity market returns.

As seen in Exhibit 1, equity markets have risen historically alongside both rising and falling long rates.

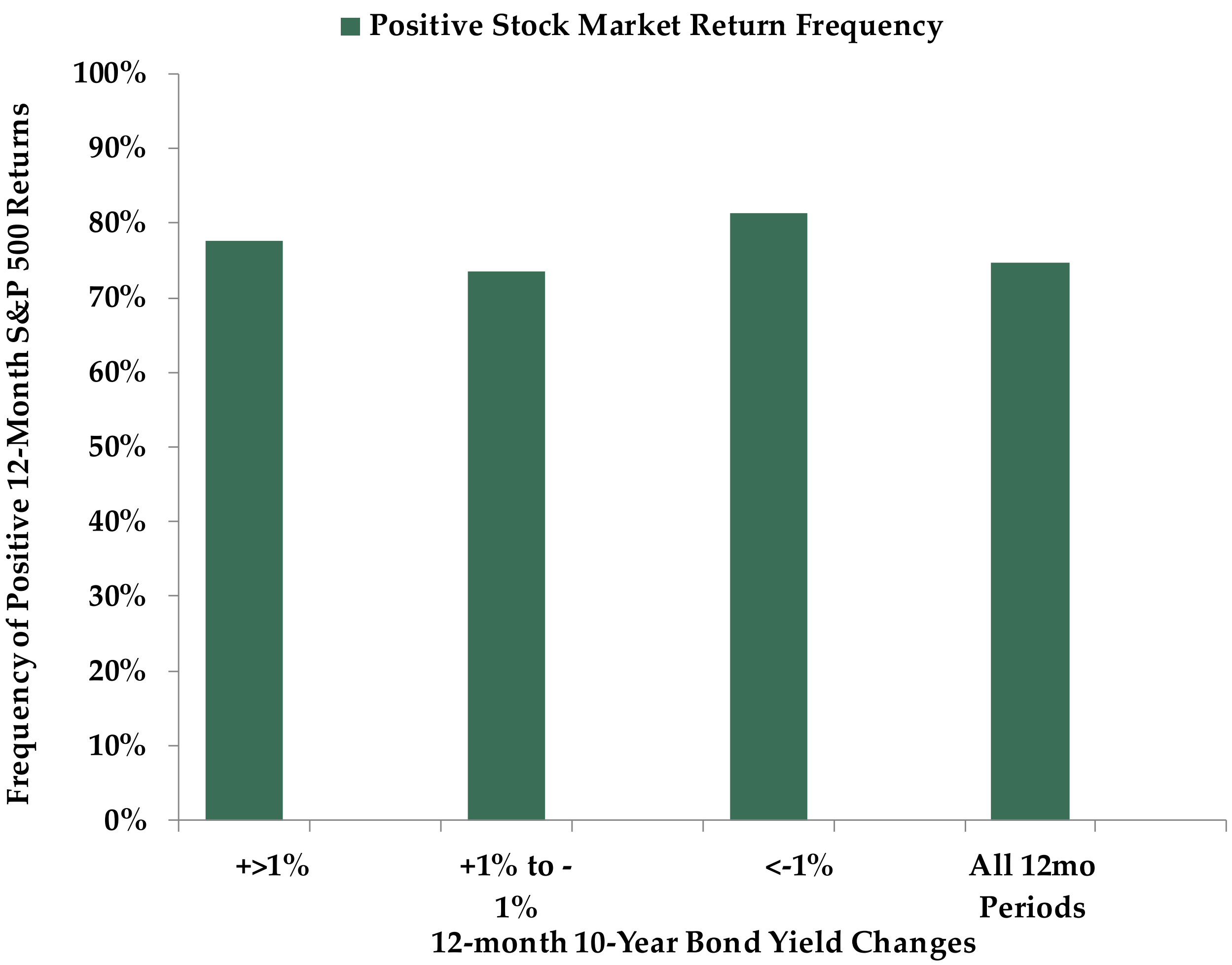
Exhibit 1: Long-Term Chart of Equities and Bond Yields



Source: Global Financial Data, as of 15/02/2018; S&P 500 Total Return Index and 10-year US government bond index yields, 31/01/1926 - 14/02/2018.

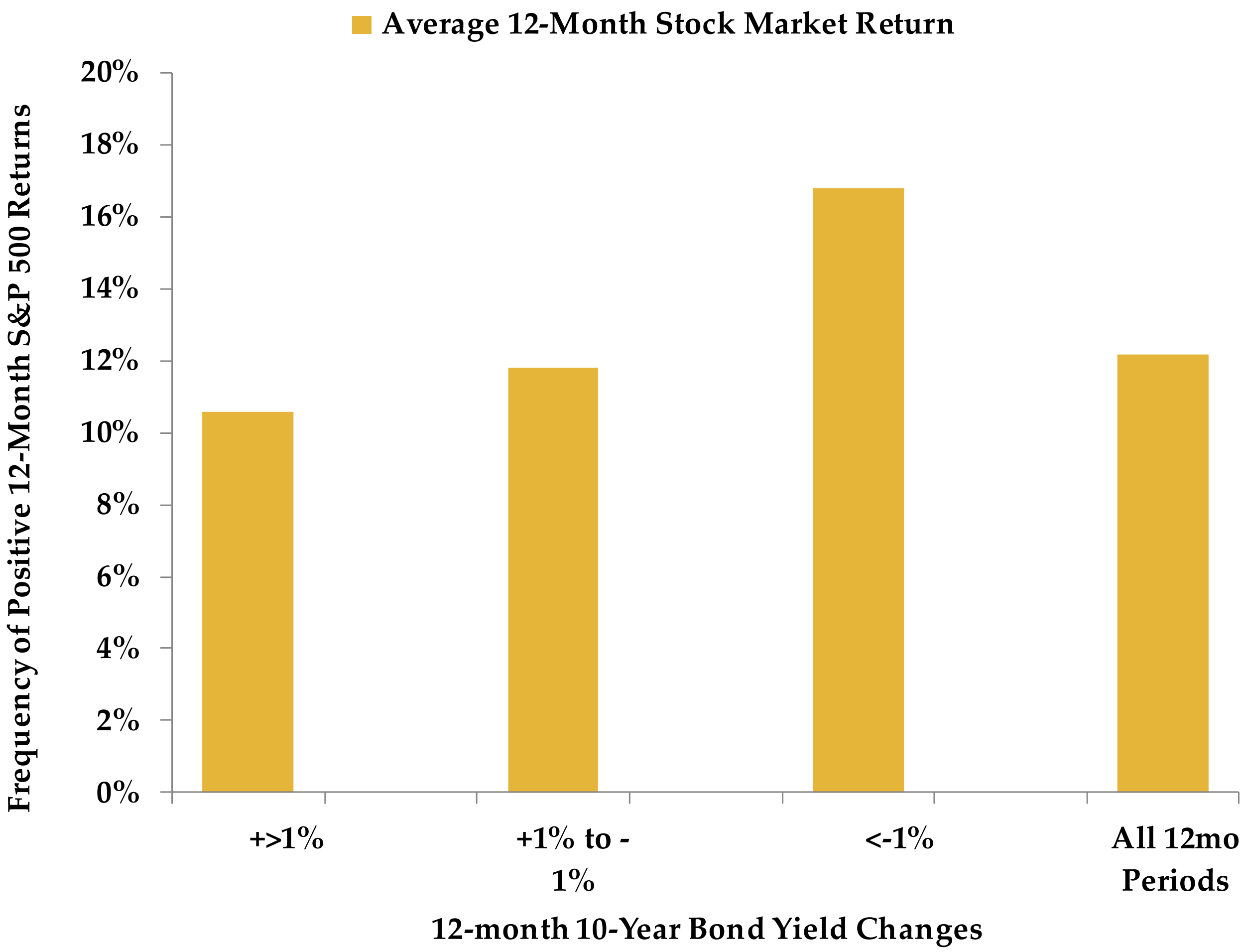
We can also gauge interest rates' impact on equities by seeing how equity markets perform following various changes in rates. Exhibit 2 shows markets are positive between ~70% and ~80% of the time regardless of whether long-term rates are falling, rising or range-bound. Exhibit 3 shows average equity returns are double-digit positive across all scenarios, too. There is no discernable pattern between interest rates' movements and equities'.

Exhibit 2: Changes in 10-Year US Government Bond Yield & Frequency of Positive Equity Market Returns



Source: Global Financial Data, as of 09/02/2018. S&P 500 Total Return Index forward 12-mo returns and 10-year US government bond index yield changes, 31/01/1926-31/01/2018.

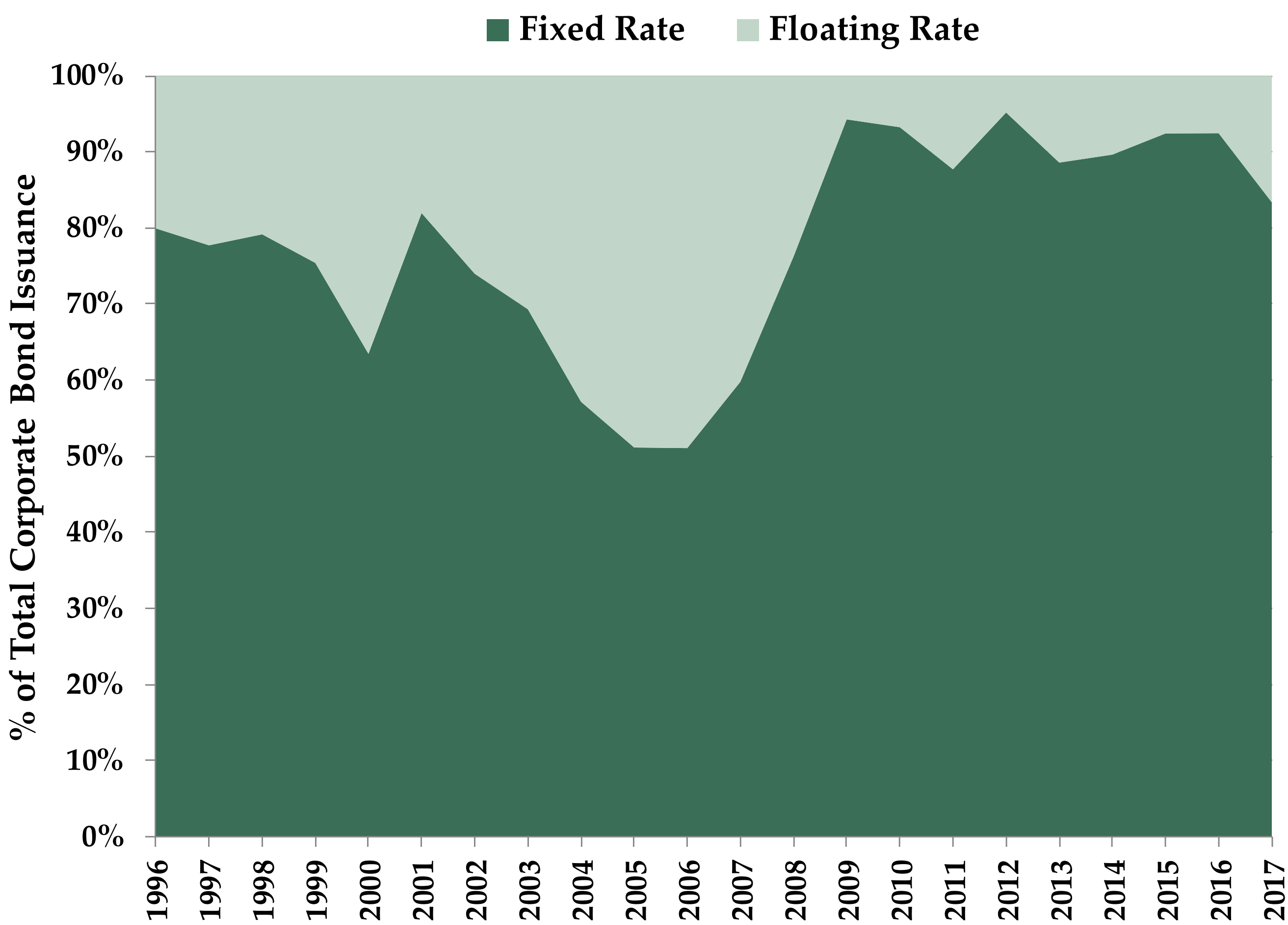
Exhibit 3: Changes in 10-Year US Government Bond Yield & Equity Market Returns



Source: Global Financial Data, as of 09/02/2018. S&P 500 Total Return Index forward 12-mo returns and 10-year US government bond index yield changes, 31/01/1926-31/01/2018.

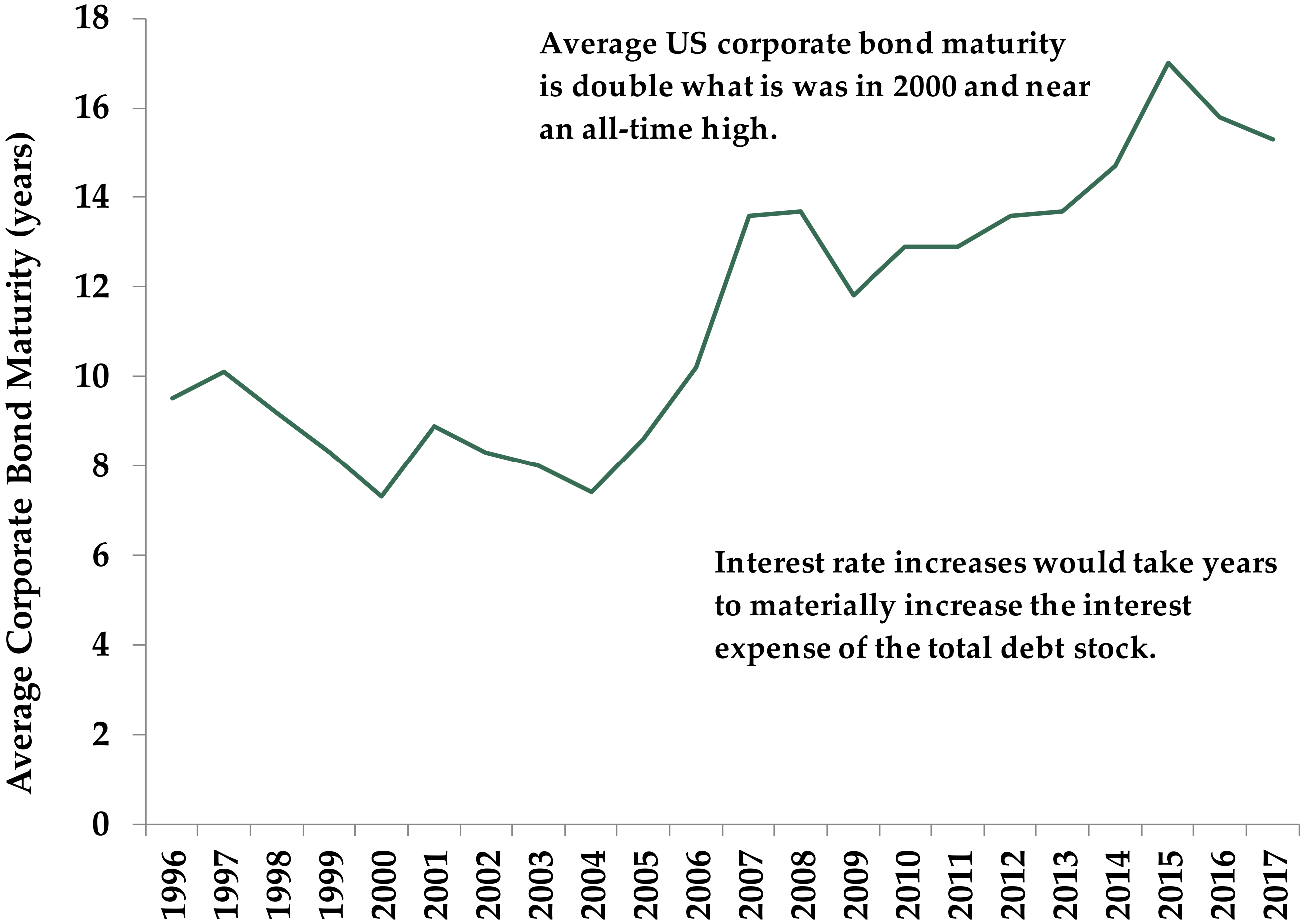
A key misperception behind the fear higher rates will hurt stocks is the impact investors assume rising rates have on corporate fundamentals. In theory, higher interest rates result in companies paying more on outstanding debt, hurting profitability. But this overlooks some important factors: First, most corporations issue debt at fixed rates—so their interest payments don't automatically rise or fall with current rates. (Exhibit 4) Further, the current average maturity of corporate debt is about 15 years. Corporate debt doesn't roll over frequently, mitigating the impact of rate changes—and that's if a company decides to re-issue debt at all. (Exhibit 5)

Exhibit 4: Fixed vs. Floating Rate Corporate Bond Issuance



Source: Securities Industry and Financial Markets Association, as of 05/02/2018. US fixed and floating rate corporate bond issuance from 01/01/1996 -01/01/2017.

Exhibit 5: Average Corporate Bond Maturity



Source: Securities Industry and Financial Markets Association, as of 05/02/2018. US corporate bond average maturity in number of years from 01/01/1996 -01/01/2017.

So long-term interest rates don't dictate equity returns. If they rise and remain there, higher rates might place limited strain on some select companies reissuing debt, but the potential impact is far from wallop worthy. In our view, these false fears are actually bullish—markets move on the difference between expectations versus reality. If markets are pricing in rising rates having a meaningful negative impact on fundamentals, and there isn't one, it increases the likelihood a positive surprise lay ahead.

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Should you have any questions about any of the information provided, please contact FIA at:
Email: Australia@Fisher-Investments.com.au
Phone: +61 180-077-0497
Mail: Level 25, Aurora Place, 88 Phillip St, Sydney NSW 2000