KOVITZ INSIGHTS

Rising Rates Do Not Portend Equity Market Doom

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Christopher Quigley
SENIOR RESEARCH ANALYST

For more than a decade, the Federal Open Market Committee (FOMC) has sustained one of the most accommodative monetary policies in the history of financial markets. The FOMC slashed rates from more than 5% to 0% during the Financial Crisis in 2008 and they stayed low thanks to multiple rounds of Quantitative Easing. In 2016, the Committee decided the economic environment was sufficiently robust to justify increasing the Federal Funds Rate (FFR). The FFR, the rate at which banks borrow overnight from each other, affects everything from economic growth to employment and climbed as high as 2.42% in April 2019. Rates were trimmed three times in 2019 before being slashed to zero when the coronavirus pandemic struck in February.

The Fed uses the FFR rate to modulate the U.S. economy. When the Fed lowers the cost of borrowing for banks, banks usually reduce the interest rates they charge for mortgages, loans and other credit lines, incentivizing borrowing. Conversely, when the Fed raises the cost of borrowing, banks usually increase the rates they charge for loans, keeping economic growth within sustainable bounds. The FOMC sets target rates for short-term lending only. As a result, near-term market rates can act independently of FOMC targets, while longer-term rates have the potential to vary even more due a wide range of other considerations. In Figure 1, we present long-term interest rates, which have ticked up slightly but remain well below long-term averages.

THE IMPACT ON VALUE STOCKS

Despite Fed Chair Jerome H. Powell's guidance that rates likely will remain in the range of 0% to 0.25% through the end of 2023, there's widespread concern that a rate hike will occur sooner rather than later thanks to a number of likely COVID-19 vaccines that might allow life to return to normal. A rising rate environment heightens concern that risk assets, including stocks, will

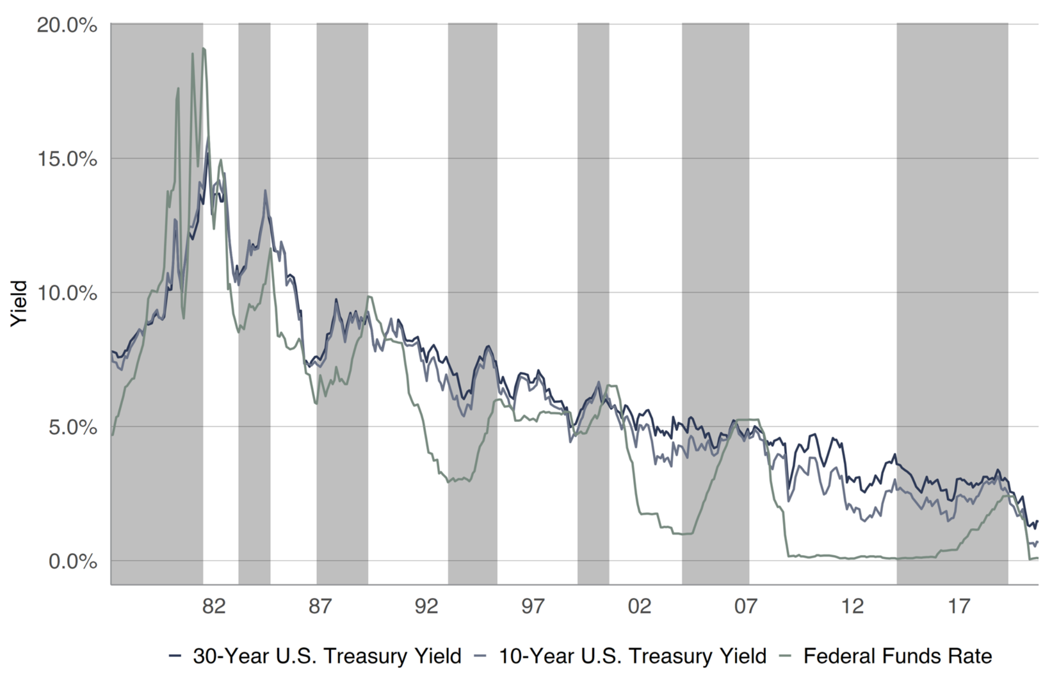
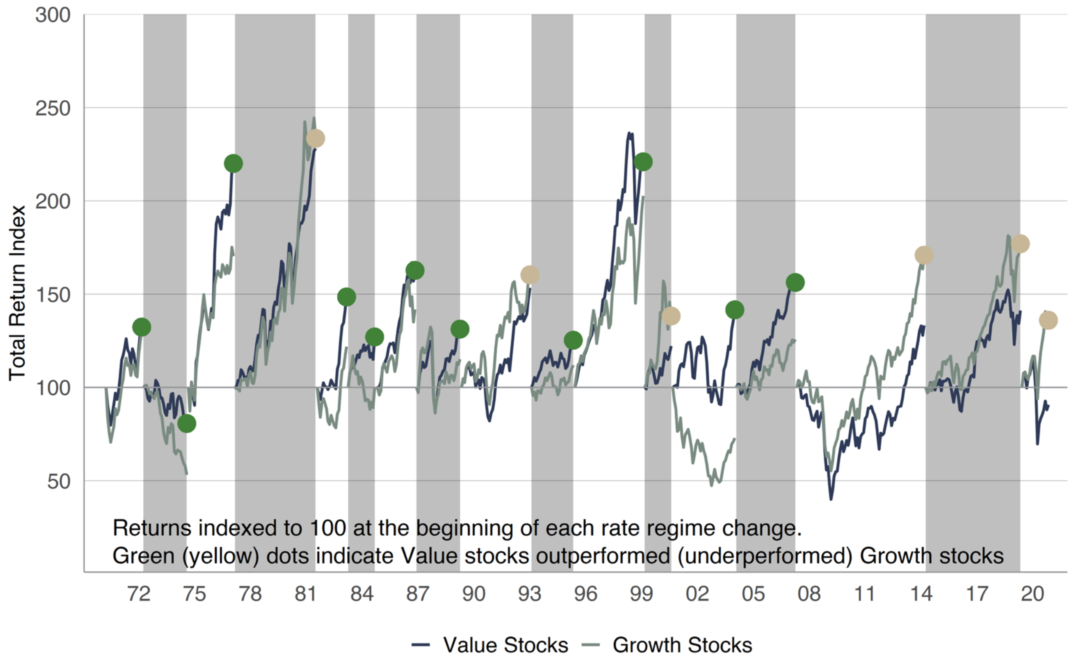


Figure 1: Long-Term Federal Funds Rate
From 02.28.1977 through 11.30.2020. Grey areas denote rising rate environments. SOURCE: Kovitz using via Bloomberg Finance L.P.

decline in price due to the higher cost of capital. We think this effect is less pronounced for Value stocks than their Growth counterparts. Yet, historical data dating back to 1969 in Figure 2 suggests that stocks are generally indifferent about the interest rate environment. When the rate environment switches between rising and falling, we reset the Value vs. Growth performance race to 100, while green dots indicate Value outperformed and yellow dots indicate Growth outperformed. Rising rate environments are shaded in grey.

Figure 2:
Interest Rates and Relative Performance

From 12.31.1969 through 10.31.2020. Performance is presented as excess total return (index returns less the risk-free rate). Grey areas denote rising rate environments. Rising (falling) rate environments are defined as periods where the Federal Funds Effective Rate rose (fell) at least 1.0% over one year or more. SOURCE: Kovitz using data from Bloomberg Finance L.P.



Since 1969, Value stocks have notched wins against Growth stocks in 11 of 17 rate environments and the margin by which they do so is substantial. In Figure 3, we compare Value and Growth stock returns in rising rate and falling rate environments using excess returns (the monthly index return less the monthly risk-free return) because it offers a rate-neutral comparison.

THE UPSHOT

We think rising rate environments are normal market phenomena and should not deter investors in stocks, especially Value stocks. Company earnings and stock prices can grow in all rate environments and we believe the next rising rate environment is unlikely to be different in that regard. As we head into 2021, we think that a continued accommodative stance from the Fed lessens the economic headwinds, while the beginning of a rising rate environment indicates that the country is no longer in the throes of a pandemic. We remain enthusiastic about the prospects for our Value-oriented, broadly diversified portfolios.

Figure 3:
The Value Advantage is Pronounced

From 12.31.1969 through 10.31.2020. Annualized performance is presented as excess total return (index returns less the risk-free rate). Rising (falling) rate environments are defined as periods where the Federal Funds Effective Rate rose (fell) at least 1.0% over one year or more. SOURCE: Kovitz using data from Bloomberg Finance L.P.

Value Stocks Outperform Regardless of the Interest Rate Environment

Interest Rate Environment	Number of Months	Value Stocks Annualized Excess Return	Growth Stocks Annualized Excess Return	Value Advantage
Rising	278	4.39%	0.26%	4.13%
Falling	332	8.56%	5.53%	3.03%

For more information on working with our financial professionals contact us at wealth@kovitz.com or 312.334.7300.

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All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The federal funds rate is the rate banks charge on loans to each other.

The quoted forward yield for the S&P 500 uses the iShares S&P 500 ETF (ticker: SPY) as a proxy. The quoted forward yield for the S&P Core Value uses iShares Core S&P U.S. Value ETF (ticker: IUSV) as a proxy. The quoted forward yield for the S&P Core Growth uses iShares Core S&P U.S. Growth ETF (ticker: IUSG) as a proxy.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

The Standard & Poors 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

From 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

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