First Trust
Monday Morning OUTLOOK

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Higher Rates, Higher Stocks

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What's happened over the past few weeks is not supposed to happen, at least if you use traditional academic-style discount models to assess the stock market. Whether you prefer a dividend discount model or an earnings discount model, both say higher interest rates should reduce the value of equities.

The idea is quite simple, at least if you're a finance professor drawing out equations on a blackboard: stocks are worth all future dividends or profits discounted to present value. So if expected future profits go up, stocks should rise. But if expected future profits remain stable while interest rates rise, then profits are worth less and stocks should go down.

But that certainly hasn't worked in the past few weeks. At the close on October 14, the federal funds futures market was putting only about a 25% chance on the Federal Reserve raising rates by the meeting on December 16. And remember, that was *before* the meeting in late October, so it reflected the total possibility of raising rates in either October or December.

Now the odds of a December rate hike are around 70%. As a result, the yield on the 10-year Treasury climbed from 1.99% on October 14 to 2.34% as of Friday, an increase of 35 basis points. This makes sense. Long-term rates mostly reflect expectations about future short-term rates. So, if investors put higher odds on a near-term rate hike – and rising short-term rates in the years ahead – then long-term yields should move up.

It also makes sense that gold fell by about 8%. Earlier rate hikes won't make monetary policy "tight." But earlier rate hikes could make the stance of policy "less loose," which undermines the argument for runaway, hyper-inflation. Rate hikes have traditionally put downward pressure on the growth rate of nominal GDP, *compared to the growth rate that would have existed had the Fed held rates lower.* This means a lower path for future inflation and therefore lower gold prices.

But, contrary to conventional wisdom, as the odds of a Fed rate hike have increased in the past few weeks, so have stock prices. Partly this is due to better economic data, but with bond yields higher and no real change in profit forecasts, the rise in stock prices has the bears perplexed. The reason the bears are so confused is that they think the entire rise in stock prices during recent years is a "sugar high" – caused solely by easy Fed policy and Quantitative Easing.

This, we think, is a huge mistake, which ignores or dismisses the massive rise in corporate earnings the US has seen in the past few years. These earnings have been driven by relentless entrepreneurship, innovation, and creativity.

This is why the market recovered from the Panic in 2008-09. During the panic, bond yields fell and stocks plummeted. Now, yields are rising and stocks are rising at the same time.

The key issue is investors' appetite for risk. When investors panic and flee from risk, bond yields and stock prices both drop. But several years into the bull market that started when mark-to-market accounting was limited, the panic is still receding. Every day more investors realize that the over-the-top "doom and gloom forecasts" just aren't coming true. Certainty and confidence are slowly returning.

It's also important to recognize that this time "it really is different." The coming rate hike cycle will be different from any other time in history. In the past, raising rates required the Fed to slow reserve growth, or actually drain reserves from the banking system, slowing or reversing money growth.

But there are currently $2.6 trillion in excess reserves and the Fed has no plans to drain them, but will instead pay banks more to hold those excess reserves. The idea is that higher rates will encourage banks not to lend, which will keep money growth (like M2) in check. In other words, there is excess liquidity in the system and the Fed is doing little to contain it.

In other words, money will not be tight any time soon, a key reason we remain bullish. Just because stocks aren't as attractive as they were in March 2009 doesn't mean they can't keep going higher. In fact, we still think the S&P 500 is at least 25% undervalued, even if interest rates move higher.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-10 / 7:30 am	Import Prices - Oct	-0.1%	**+0.2%**		-0.1%
7:30 am	Export Prices - Oct	-0.3%	**-0.5%**		-0.7%
11-12 / 7:30 am	Initial Claims - Nov 7	270K	**267K**		276K
11-13 / 7:30 am	PPI – Oct	+0.2%	**-0.1%**		-0.5%
7:30 am	"Core" PPI – Oct	+0.1%	**0.0%**		-0.3%
7:30 am	Retail Sales - Oct	+0.3%	**+0.2%**		+0.1%
7:30 am	Retail Sales Ex-Auto - Oct	+0.4%	**+0.3%**		-0.3%
9:00 am	Business Inventories - Sep	0.0%	**0.0%**		0.0%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.