Truist Advisory Services, Inc.

Market Perspective from the Investment Advisory Group

Higher Rates, Higher Stocks, Higher Volatility

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Key takeaways

- We see the rise in rates as a natural progression as the economic outlook improves.
- The S&P 500 has averaged an annualized total return of 13% and increased in 81% of the rising rate periods (13 out of 16), including the low-rate environment of the 1950s.
- Expect periodic market tantrums as investor perception of Fed policy shifts, but the bull market remains intact.

What happened?

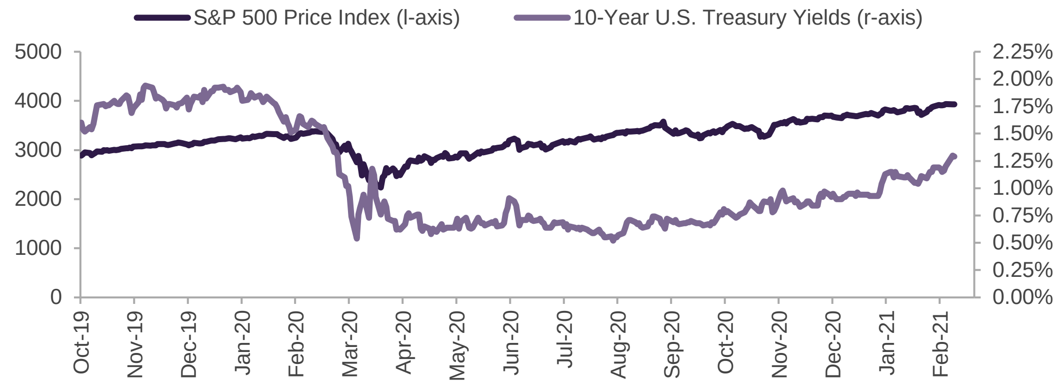
The recent sharp rise in the 10-year U.S. Treasury yield—which went from 1.0% towards the end of January to above 1.3% recently—is causing investor concerns about the risks to the stock market. With yields approaching levels seen early in the pandemic, the question is whether this will put a dent in the stock market's premium valuation and diminish the relative appeal of equities.

Our take

Although higher rates are likely to inject volatility into the market as investors debate when the Federal Reserve (Fed) will have to pull back from its ultra-loose monetary policy, we see the rise in rates as a natural progression as the economic outlook improves.

Indeed, stocks and yields were moving up together prior to the pandemic, and then fell sharply during the crisis. Yields had been lagging the move higher in stocks until recently and are now playing catch up.

Stocks and yields fell into the pandemic and are rising alongside an improving economic outlook



Data Source: Truist IAG, FactSet

TRUIST Wealth

Historically, rising rates and stocks have often gone hand-in-hand. Looking back at 16 rising rate periods over roughly the past 70 years, the S&P 500 has averaged an annualized total return of 13% and risen in 81% of the periods (13 out of 16). Two of the periods that showed negative returns overlapped with recessions, something we view as very unlikely over the next year.

The S&P 500 has averaged an annualized return of 13% and risen in 81% of the time (13 out of 16) during rising rate periods.

Stocks have tended to increase during rising interest rate periods

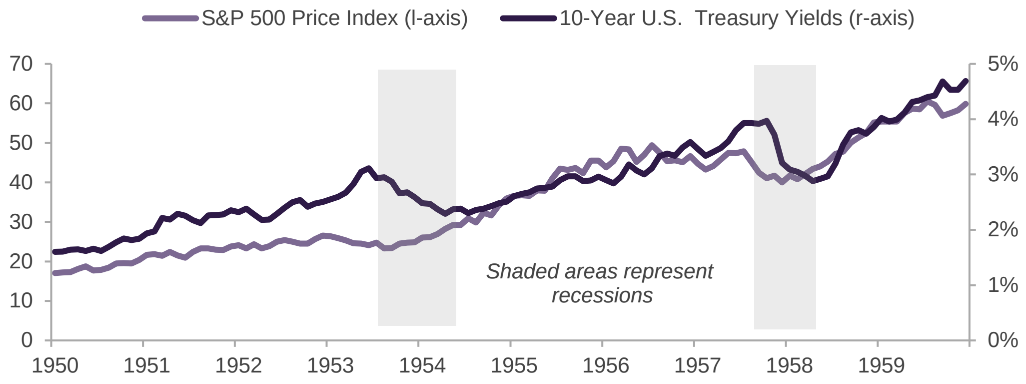
Rising Rate Periods		Starting 10-Yr Treasury Yield (%)	Ending 10-Yr Treasury Yield (%)	Change in 10-Yr Treasury Yield (%)	S&P 500 Annualized Total Return (%)	S&P 500 Cumulative Total Return (%)
8/31/1949	6/30/1953	1.5	3.1	1.6	21	105
4/30/1954	10/31/1957	2.3	4.0	1.7	16	68
4/30/1958	1/31/1960	2.9	4.7	1.8	19	36
5/31/1961	8/31/1966	3.7	5.4	1.7	6	37
3/31/1967	5/31/1970	4.5	8.0	3.5	-2	-6
3/31/1971	9/30/1975	5.5	8.5	3.0	-0.4	-2
12/31/1976	2/29/1980	6.8	12.7	5.9	7	25
6/30/1980	9/30/1981	10.1	15.8	5.8	7	8
4/30/1983	5/31/1984	10.3	13.9	3.6	-4	-4
8/31/1986	9/30/1987	7.0	9.6	2.7	29	32
9/30/1993	11/30/1994	5.4	7.9	2.5	2	2
9/30/1998	1/31/2000	4.4	6.7	2.2	28	39
5/31/2003	6/30/2006	3.4	5.2	1.8	11	39
12/31/2008	12/31/2009	2.3	3.9	1.6	26	26
7/31/2012	12/31/2013	1.5	3.0	1.5	26	38
7/31/2016	10/31/2018	1.5	3.2	1.7	13	31
Average		**4.6**	**7.2**	**2.7**	**13**	**30**

Data Source: Truist IAG, Haver, Morningstar. Past performance does not guarantee future results.

Stocks also did well coming out of the very low interest rate environment of the 1950s. While there are many differences versus today, there were some similarities such as very high U.S. debt levels as a result of the war, an activist Fed, and a post-war boom in the economy. Interest rates rose from 1.5% at the beginning of the decade to nearly 5% by the end. During the decade, despite two recessions, the S&P 500 rose 257% based on price and 487% on a total return basis.

Despite interest rates rising from 1.5% at the beginning of the 1950s to nearly 5% by the end, the S&P 500 rose 257% based on price and 487% on a total return basis.

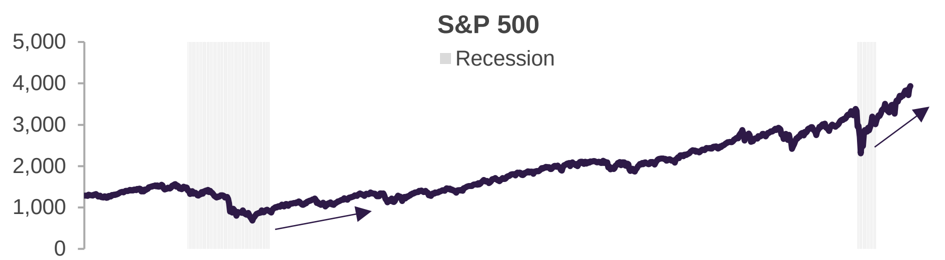
Stocks & yields generally rose together during the low-rate environment of the 1950s

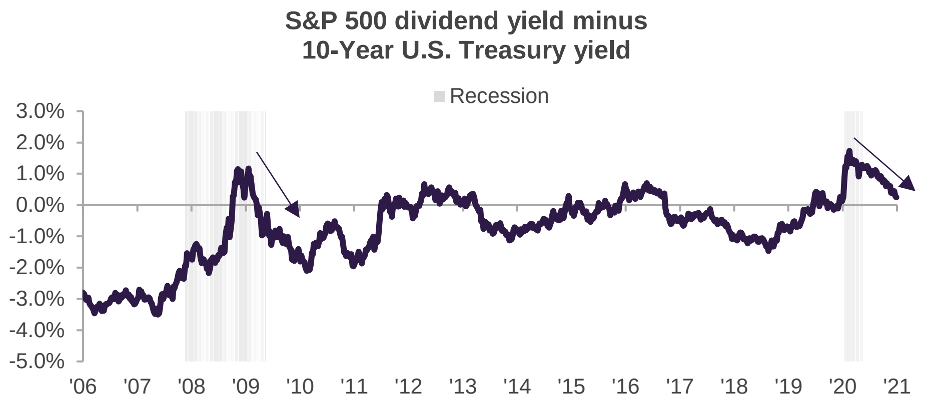


Data Source: Truist IAG, Haver. Past performance does not guarantee future results.

More recently, stocks' dividend advantage compared to the 10-year U.S. Treasury yield has been declining, but remains attractive on a relative basis. Notably, the trajectory of this comparative relationship is very similar to what happened coming out of the financial crisis, as stocks moved to the next phase of the bull market.

Stocks' dividend advantage relative to rates has been declining, but the trajectory is very similar to the path coming out of the financial crisis.



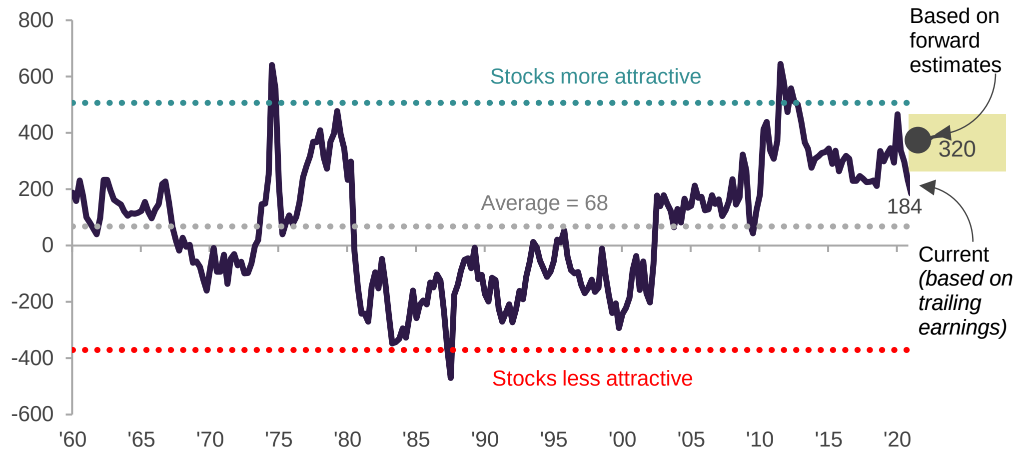


Data Source: Truist IAG, FactSet

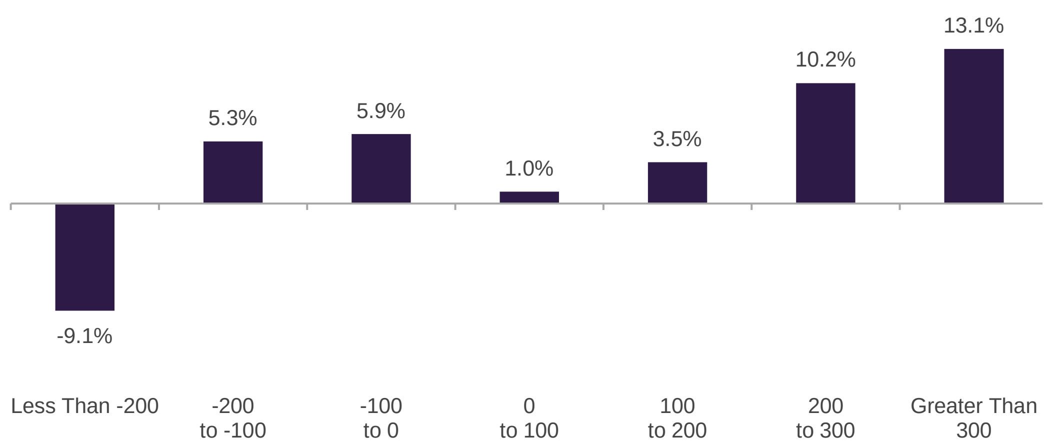
Still, with the rise in the stock market alongside the increase in interest rates, the relative attractiveness of stocks to bonds has fallen to the lowest since 2010, using the equity risk premium (ERP). This metric compares the earnings yield (inverse of the P/E) of stocks relative to the 10-year U.S. Treasury yield. However, the trailing earnings yield is artificially low given the pandemic-related collapse in profits and should improve sharply in 2021 given a spring-loaded economy. Consequently, stocks still appear favorable on a comparative basis to fixed income and cash.

Although the equity risk premium (ERP) has declined, it still suggests stocks remain attractive on a relative basis.

S&P 500 – Equity Risk Premium*:
Earnings yield minus 10-year Treasury yield



Average 12-month forward S&P 500 excess return over the 10-year Treasury return by ERP tranche (1960-Current)



Data Source: Truist IAG, Haver, Morningstar, FactSet; Past performance does not guarantee future results.
*The equity risk premium (ERP) compares the earnings yield of stocks (inverse of the P/E ratio) to the 10-year U.S. Treasury yield. ERP is quantified in basis points (bps). One basis point = 0.01%

Positioning

We remain overweight equities on a 12-month basis. Our expectation for a better economy and little value in rates are among the reasons we added to equities and downgraded fixed income to less attractive last October, though we have maintained a credit overweight. Higher rates are also a positive for financials, the largest sector in the value style. We upgraded financials to an overweight in our sector strategy earlier this year. This shift also contributed to our recent removal of our growth style tilt.

Bottom Line

We do not see the recent increase in yields as a threat to the bull market. Instead, we see the rise in yields as a sign of growing confidence in the economic recovery. From a stock market perspective, rising rates should be countered by stronger earnings. That said, much like we saw tantrums in the market periodically over the past decade when the Fed pulled back monetary accommodation, or simply the market's perception of when that shift would occur, we expect these tantrums to ensue during this cycle. In fact, one could argue that given how aggressive the Fed has been, stocks may become even more sensitive to Fed policy changes, real or perceived, than previously.

Recent market behavior is also consistent with our view that, after the initial snapback rally, we are in the next phase of the bull market—suggesting positive but moderating returns—and likely a choppier environment. Still, given that we are in the early stages of an economic recovery, monetary and fiscal policy remains supportive, the sharp rebound in earnings, and favorable relative valuations, we maintain our overweight to equities.

Disclosures

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