April 16, 2024

US Strategy Comment

Rate Worries Resurface Yet Again

Rising Interest Rates Causing Investor Consternation, but Should They?

Interest rates worries have re-emerged in recent weeks following several hotter-than-expected CPI prints and a series of upside surprises from key economic reports. This combination has seemingly shifted investor Fed rate cut expectations significantly, with the market now pricing in only two 25 bps cuts for 2024 vs. the seven expected at the start of the year. As a result, the 10-year Treasury yield has jumped more than 50 bps since early March, the largest uptick since the ~90 bps move higher during September-October 2023, with current levels getting closer to the psychological 5% barrier, something last seen in 2007. Once again, this move has many investors contemplating how much longer the 2024 YTD market rally can last should interest rates continue to rise or stay elevated, based on our client conversations. However, our work shows that investors should not fear higher rates, despite current conventional thinking to the contrary. In fact, we found that some of the strongest periods of S&P 500 performance have coincided with rising or higher levels of interest rates over the past few decades. However, the era of "easy money" investing is likely behind us, and the transition to a more "normal" rate structure is likely to be challenging causing many fits and starts for market performance in the coming months as it adjusts to this reality, in our view. Thus, we believe it is important for investors to fall back on their disciplines and maintain an active approach when searching for opportunities.

Main Points:

- Crisis Level Rates Were Never "Normal"
  - ✓ The Great Financial Crisis (GFC) and its drastic policy response conditioned a large part of this generation of investors to view what had been historically low levels of interest rates as the "new normal"
  - ✓ Now that containing inflation has become the number one policy goal, interest rates are likely to remain elevated and closer to pre-GFC historical norms
- Higher Interest Rates Have Actually Been Better for Stocks Historically
  - ✓ Despite perceptions to the contrary, US stocks have performed better during periods of higher or rising interest rates
  - ✓ In fact, the market has posted its strongest gains with moderate increases in yields, specifically 0-100 bps Y/Y

Implementation Strategies:

- US Tactical Equity, US Dividend Growth, and US Disciplined Value portfolios
- Please see US Strategy Portfolios and Investment Strategy Portfolios for recent changes

BMO Capital Markets

Investment Strategy

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US Strategy – S&P 500 Targets

Price Target Model	2024E
DDM	5,175
Fair Value P/E	5,050
Price Target	**5,100**
EPS Target Model	**2024E**
Macro Regression	$240
Bottom-Up Consensus	$245
Normalized EPS	$205
EPS Target	**$250**
Implied P/E	**20.4x**

Source: BMO Capital Markets Investment Strategy

US Strategy – Recommended S&P 500 Sector Weightings

Sector	Opinion	Tgt. Wgt.
Communication Services	MW	9%
Consumer Discretionary	MW	11%
Consumer Staples	UW	5.5%
Energy	UW	3.5%
Financials	OW	13.5%
Health Care	MW	12.5%
Industrials	MW	8.5%
Information Technology	OW	30%
Materials	UW	1.5%
Real Estate	MW	2.5%
Utilities	MW	2.5%

Source: BMO Capital Markets Investment Strategy

OW: Overweight
MW: Market Weight
UW: Underweight

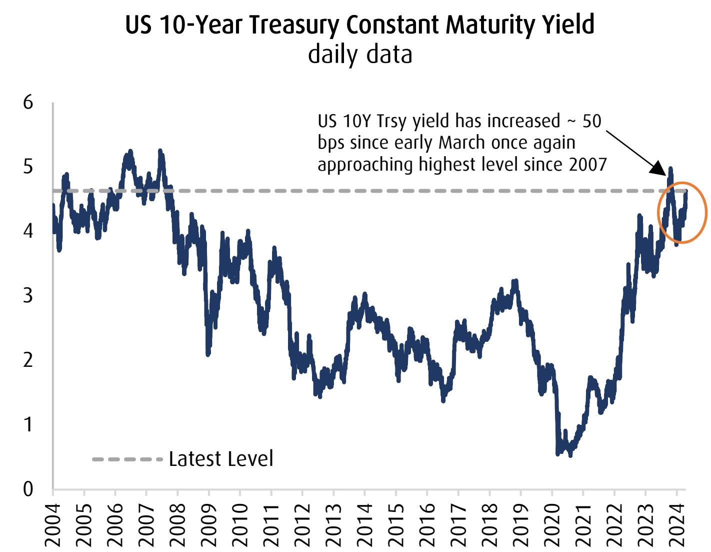
16:01 ET~

Rate Worries Resurface Yet Again

Rising Interest Rates Causing Investor Consternation, but Should They?

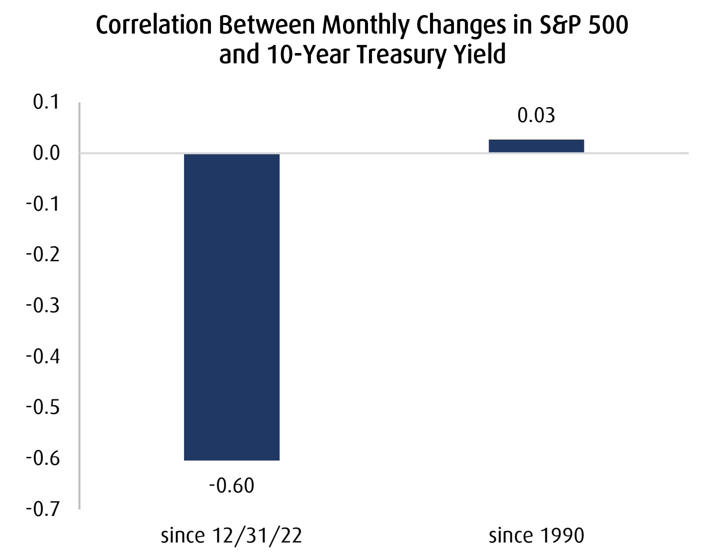
After a relentless move higher from its October 2023 low where the S&P 500 delivered gains in 17 out of 20 weeks, the index has stumbled recently and is on pace for its third consecutive weekly loss. The culprit has been a familiar foe – interest rate worries – which have re-emerged following several hotter-than-expected CPI prints and a series of upside surprises in key economic reports. This combination has certainly shifted market expectations in recent weeks, as investors are now pricing in only two Fed 25 bps rate cuts for 2024, down from seven at the start of the year. This shift in sentiment has had a clear impact on Treasury yields as the CMT 10-year rate has jumped more than 50 bps since early March (Exhibit 1), the largest uptick since the ~90 bps move higher during September-October 2023, with current levels getting closer to the psychological 5% barrier, something last seen in 2007. And considering that stocks and rates have traded in almost inverse lockstep since the end of 2022, interest rate movements and potential stock market implications are clearly a significant investor focus. However, despite perceptions the recent relationship between stocks and rates has been unusual compared to historical data, which has shown little correlation between the two (Exhibit 2). This is part of the reason that while we do subscribe to the "higher-for-longer" interest rate narrative, we are less concerned than investors about recent levels and trends. Current conventional thinking seems to suggest that any form of higher yields is automatically bad for stocks. However, our work shows quite the contrary with some of the strongest periods of market performance coinciding with rising or higher interest rates over the past few decades. As such, we do not view the prospect of higher yields alone as a threat to the bull market, but with the days of "easy money" long gone it will likely be more challenging for investors to identify opportunities and deliver outperformance as market performance is likely to have many fits and starts along the way as it adjusts to this reality, in our view. This is part of the reason we have been advocating a highly selective approach to US stock portfolio positioning for much of the past year.

Exhibit 1: US 10Yr Treasury Yield Has Had Its Largest Jump Since October 2023 in Recent Weeks



Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Exhibit 2: Stocks and Rates Have Shown a Strong Relationship Lately, but This Is at Odds With Historical Norms

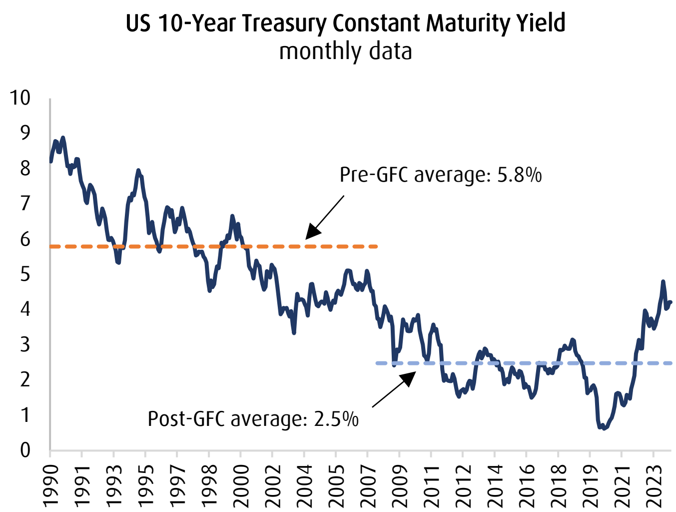


Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Crisis Level Rates Were Never "Normal"

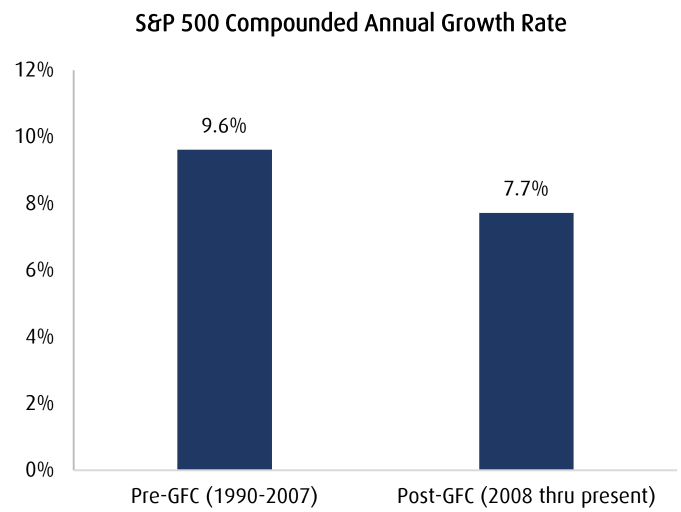
From our perspective, the Great Financial Crisis (GFC) and its drastic policy response conditioned a large part of this generation of investors to view what had been historically low levels of interest rates as the "new normal". We never agreed with this line of thinking but can understand why so many investors have been shaken by the rise in yields over the past couple of years – many have never invested in a world where interest rates were not "zero". In fact, it may come as a surprise to some that the stock market performed quite well before acronyms like ZIRP or terms like quantitative easing ever became part of the lexicon. For instance, as Exhibits 3-5 show, from 1990 through 2007 (the pre-GFC period) the average 10-year Treasury yield was 5.8% while the S&P 500 delivered a 9.6% CAGR and had an average NTM P/E of 19.9x. By contrast, since 2008 (the post-GFC period), the average 10-year Treasury yield has been 2.5% with the S&P 500 delivering a 7.7% CAGR and an average NTM P/E of 17.3x. In other words, the S&P 500 performed better and had a higher valuation during a period of significantly higher average interest rates. Admittedly, this may be an oversimplification, but the data are the data. This also highlights another important and overlooked point, in our view, which is there has been little correlation between longer-term changes in interest rates and stock market performance historically (Exhibit 6).

Exhibit 3: Average Yields Were Much Higher Pre-GFC



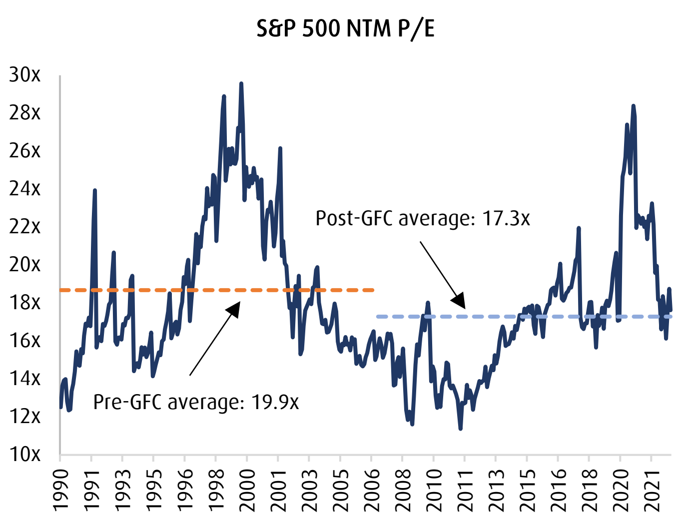
Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Exhibit 4: Stocks Performed Better in Yesteryear's Rate Environment



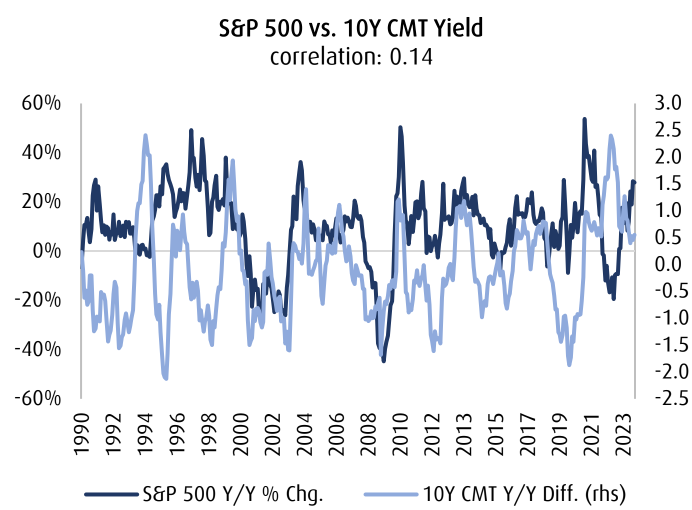
Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Exhibit 5: S&P 500 Average Valuation Was Higher Pre-GFC



Source: BMO Capital Markets Investment Strategy Group, Bloomberg.

Exhibit 6: Stocks Have Had Little Correlation to Interest Rate Changes



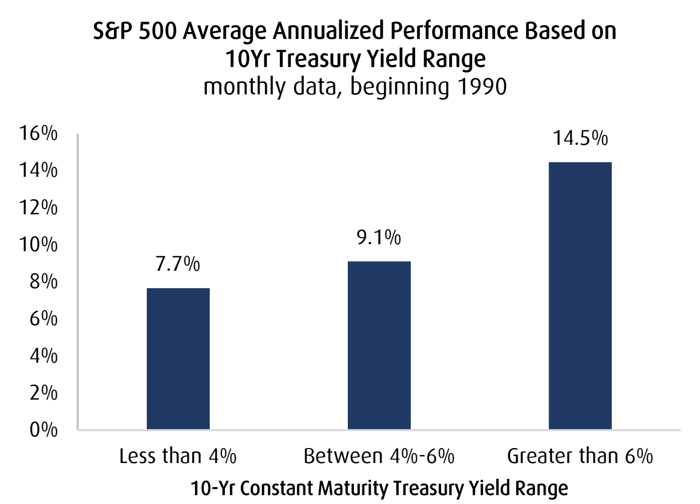
Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Higher Interest Rates Have Actually Been Better for Stocks Historically

Conventional thinking is that high or rising interest rates are always bad for stock market performance and based on the above-mentioned, it appears that interest rates are more likely than not staying higher relative to the post-GFC average, which has worried many investors. However, a closer inspection of the data reveals that investors should not necessarily fear higher interest rates if history is any sort of guide. For instance, we analyzed all rolling one-year periods, as well as cycles where interest rates increased for at least one year since 1990, and calculated S&P 500 performance under these various interest rate scenarios. We summarized our findings in Exhibits 7-11. The highlights of our analysis are as follows:

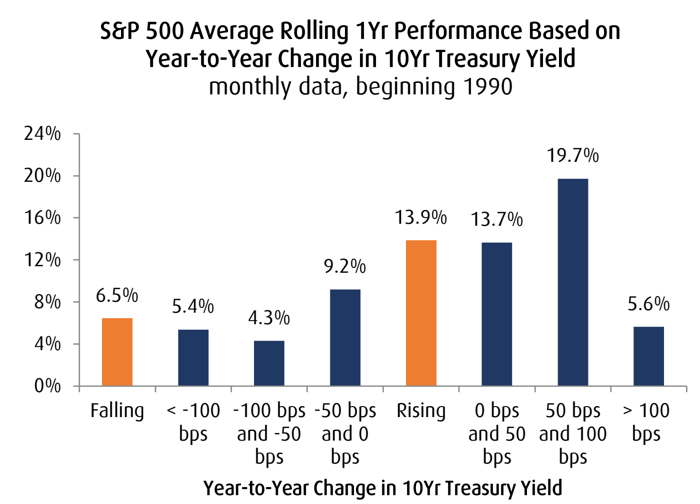
- Low levels of interest rates are not necessarily the best environment for US stock market performance. For instance, the S&P 500 delivers stronger average price returns and has a higher probability of gains at higher levels of interest rates compared to lower levels of interest rates. This makes sense to us since lower rates can be reflective of sluggish economic growth and vice versa.
- Rising interest rates have seemingly benefited US stock market performance. In fact, the S&P 500 has posted an average price return of 13.9% during periods of increasing rates compared to just a 6.5% average gain during periods of falling rates. In fact, moderate yield level increases (i.e., between 0-100 bps) have exhibited the strongest returns of all periods. In addition, during the eight interest rate cycles we identified since 1990 in which yields increased for prolonged periods, the S&P 500 logged an average annualized price gain of ~15%. From our perspective, rising interest rates can mean that the bond market is correctly anticipating future economic growth and staying ahead of inflation – things that typically benefit stock prices.

Exhibit 7: Higher Yield Levels Have Not Impacted S&P 500 Historically



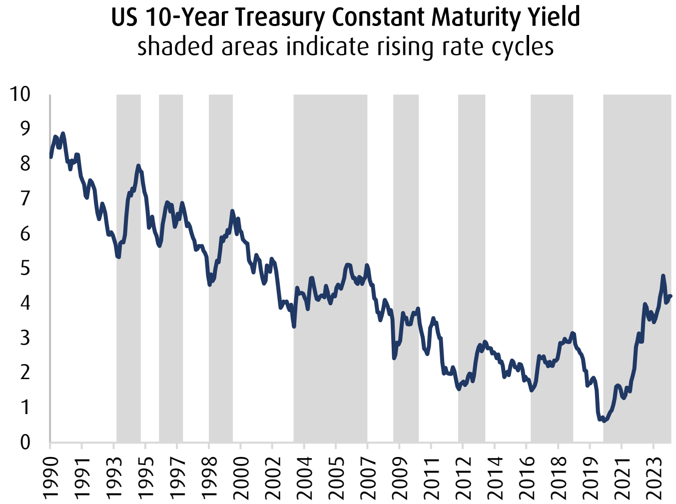
Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Exhibit 8: S&P 500 Has Done Better When Rates Were Increasing



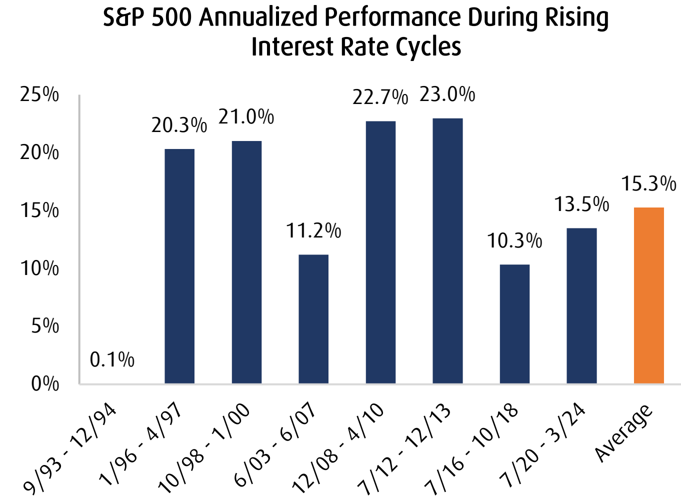
Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Exhibit 9: There Have Been Several Prolonged Periods of Rising Interest Rates Since 1990



Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Exhibit 10: S&P 500 Has Posted Solid Annualized Price Returns During Increasing Interest Rate Cycles



Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Exhibit 11: Analysis of S&P 500 Price Performance and Interest Rate Scenarios
based on month-end data beginning 1990

Average S&P 500 Performance and Interest Rate Regime
(rolling 1-year periods, month-end data)

10Yr Treasury Yield	% Occurrence	Price Change	Risk Ratio	Hit Rate
Less than 4%	48.5%	7.7%	0.77	72.7%
Between 4%-6%	32.3%	9.1%	0.58	78.9%
Greater than 6%	19.3%	14.5%	1.33	92.2%

Average S&P 500 Performance and Interest Rate Trajectory
(rolling 1-year periods, month-end data)

Change in 10Yr Treasury Yield	% Occurrence	Price Change	Risk Ratio	Hit Rate
Rising	40.3%	13.9%	1.05	85.1%
Falling	59.8%	6.5%	0.38	74.1%
Less than -100 bps	17.8%	5.4%	0.30	66.7%
Between -100 bps and -50 bps	20.5%	4.3%	0.22	72.2%
Between -50 bps and 0 bps	22.3%	9.2%	0.74	81.8%
Between 0 bps and 50 bps	14.0%	13.7%	1.30	87.3%
Between 50 bps and 100 bps	16.5%	19.7%	1.65	100.0%
Greater than 100 bps	9.0%	5.6%	0.40	60.0%

Rising Interest Rate Cycles and S&P 500 Performance

Date Range	Duration (months)	Yield Change (bps)	S&P 500 Price Change (annualized)
9/1993 - 12/1994	15	245	0.1%
1/1996 - 4/1997	15	124	20.3%
10/1998 - 1/2000	15	213	21.0%
6/2003 - 6/2007	49	177	11.2%
12/2008 - 4/2010	16	143	22.7%
7/2012 - 12/2013	17	137	23.0%
7/2016 - 10/2018	27	165	10.3%
7/2020 – 3/2024	45	359	13.5%
Average:	**25**	**195**	**15.3%**

Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Note: The risk ratio is the average return divided by the standard deviation of returns used to calculate the average return. The hit rate is the percentage of positive returns for the period.

Recent US Strategy Research Reports

Date	Title
	Comments and Snapshot Reports
3/26/2024	US Strategy Comment: Small and Mid-Cap Check Up
3/21/2024	US Strategy Comment: Revisiting Our Style Recommendations
3/13/2024	US Strategy Comment: Navigating the Range
2/27/2024	US Strategy Comment: S&P 500 Target Update, Holding Steady
2/15/2024	US Strategy Comment: YARP Primed for a Turnaround
2/6/2024	US Strategy Comment: Market Concentration Worries May Be Overstated
1/18/2024	US Strategy Comment: 2024 Off to a Wobbly Start
1/9/2024	US Strategy Comment: Technology Remains a Top Sector Pick
12/13/2023	US Strategy Comment: How to Own Both Growth and Value for 2024
11/15/2023	US Strategy Comment: Three Observations to Help Climb the Wall of Worry
10/26/2023	US Strategy Comment: High Dividend Yield Weakness Likely Overdone
10/18/2023	US Strategy Comment: Happy Birthday Bull Market
	Monthly Reports
4/3/2024	US Strategy: US Chartbook – April 2024
4/3/2024	US Strategy: US Factor Profiles – April 2024
4/3/2024	US Strategy: US Multi-Factor Profiles – April 2024
	Investment Strategy Snapshots and Special Reports
11/27/2023	2024 Market Outlook - The Year Ahead for the U.S. and Canada

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Rating category	BMO rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	StarMine Universe~
Buy	Outperform	49.2 %	18.9 %	46.2 %	55.7 %	57.3 %	57.7%
Hold	Market Perform	48.4 %	21.4 %	51.6 %	42.9 %	41.8 %	37.5%
Sell	Underperform	2.4 %	18.2 %	2.2 %	1.4 %	0.9 %	4.8%

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(April 2013 - October 2016)
http://researchglobal.bmocapitalmarkets.com/documents/2013/rating_key_2013_to_2016.pdf

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