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Three steps and rumble

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As the U.S. Federal Reserve prepares to raise interest rates this week for the third time in this recovery, the old Wall Street adage of "Three Steps and Stumble" is understandably on the minds of many investors. The popular proverb reflects a historical tendency for the U.S. stock market to suffer a setback once the Fed raises interest rates for the third time in a recovery cycle. Anxieties about the impact of higher interest on the stock market have also been heightened because the 10-year U.S. Treasury bond yield has risen by about 1.25% since last summer.

We caution equity investors against becoming too pessimistic about Fed action this week. The mindset of the marketplace is currently very different compared to recent decades when the Fed raised interest rates and when the "Three Steps and Stumble" rule was popularized. Indeed, because the correlation between the stock market and bond yields is unusually positive today, even though the Fed is finally starting to increase interest rates, rather than stumble soon, the stock market may just continue to rumble.

Inflation / deflation mindset of investors

Historically, the sensitivity of the stock market to rising interest rates depends primarily on whether investors are more worried about inflation or deflation. When the consensus is anxious about inflation risk, rising yields are often damaging to the stock market. However, when deflation is the dominant fear, the stock market has done quite well when yields rise.

We think the correlation between stock prices and bond yields reflects investor attitudes about potential inflation / deflation risks. Chart 1 illustrates the rolling three-year trailing correlation between monthly changes in the 10-year bond yield and monthly percent changes in the U.S. stock market since 1900. The dotted lines represent quintile breakpoints for this correlation over the entire 117-year period. A negative correlation (i.e., when rising yields are associated with falling stock prices) results when inflation is perceived as the primary problem. In this case, improved economic reports often hurt both bond and stock prices since they represent harbingers of increased inflationary potential. Conversely, when deflation is the central focus, the correlation between stock prices and interest rates is positive. With this mindset, a better economic report simply signifies less risk of a deflationary abyss pushing both yields and stock prices higher.

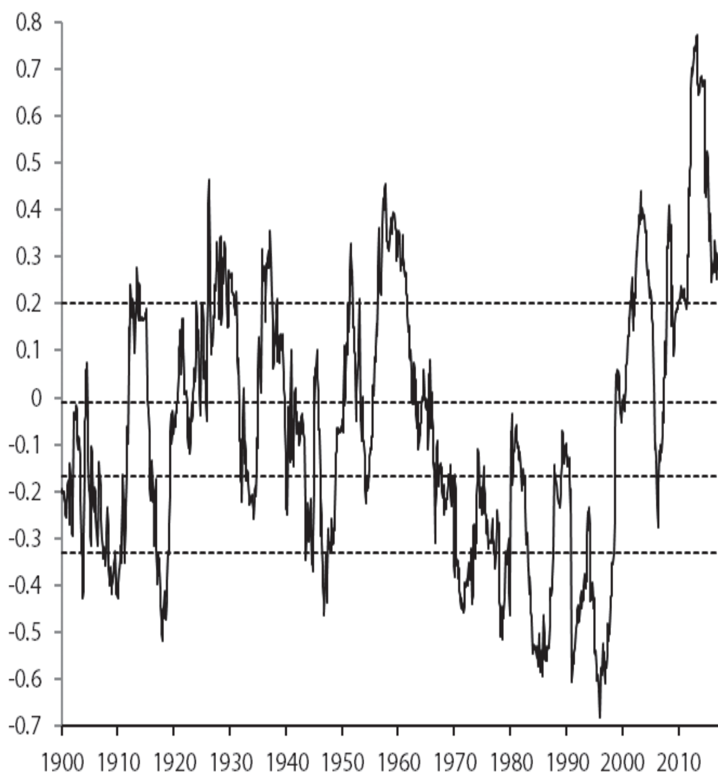
Inflation fears dominated and correlations were extremely negative during the high inflation eras in both WWI and WWII (i.e., see the low correlations in Chart 1 during the late 19-teens and in the 1940s). Likewise, due to the chronic high inflation rates endured during the 1970s, investor's feared inflation for almost two decades after inflation peaked in the early 1980s. Accordingly, the correlation between stock prices and bond yields was deeply negative between 1970 until almost 2000. During this prolonged era of persistent inflation anxieties, improved economic growth, rather than being good for stocks, often simply aggravated inflation expectations and pushed yields higher and stock prices lower.

By contrast, deflationary mindsets were persistent during the Great Depression, in the aftermath of WWII during the 1950s and since the late-1990s when the Japanese depression, 1997 Asian deflationary abyss, the 1998 Russian deflationary debacle, the 2000 dot-com deflationary meltdown and the Great Deflationary Recession of 2008 combined to perpetuate deflationary fears. Appropriately, the correlation between stock prices and bond yields has been mostly positive since 2000. That is, rising yields have most often been associated with a rising stock market because improved economic growth, rather than worsening investor inflation fears, has simply lessened deflation fears.

Chart 1

Stock-bond correlation history*
1900 to 2017

*Trailing 36-month rolling correlation coefficient between monthly percent changes in the U.S. stock market and monthly changes in the 10-year U.S. Treasury bond yield. Dotted lines represent quintile break points.
Data source: Robert Shiller and Bloomberg.



Assessing interest rate risk for stocks — The historical record

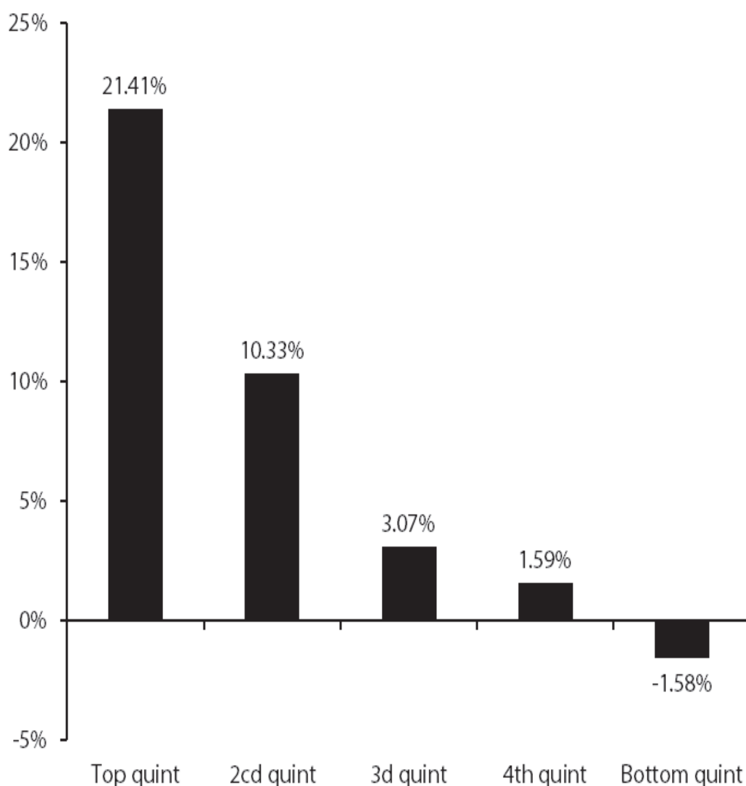
When assessing the impact rising yields may have on the stock market, obviously it is important to gauge whether investor mindsets are primarily focused on inflation or deflation. Rising interest rates in a world where investors worry about inflation (i.e., when the correlation in Chart 1 is negative) is typically damaging for both the stock market and the bond market. However, if the predominant concern is deflation (i.e., when the correlation is positive), when yields rise, the stock market often performs well.

In the last year, bond yields have risen and the Fed now appears poised to raise the funds rate for a third time this week. Does this mean the stock market is headed for a stumble? Perhaps, but as shown in Chart 2, as long as the correlation between the stock market and bond yields remains so positive, history suggests it is more likely that the stock market simply keeps climbing as yields rise.

Chart 2

Annualized U.S. stock market price gains for all months since 1900 when the 10-year Treasury bond yield increased by stock market - bond yield correlation quintiles*

*When the trailing 36-month stock market - bond yield correlation was among the highest quintile readings since 1900, and bond yields rose during 127 of those months. During these 127 months, the U.S. stock market increased by an average monthly percentage of 1.63% or 21.41% annualized. By contrast, there were 128 months since 1900 when the stock market - bond yield correlation was in the bottom quintile while bond yields rose and U.S. stocks on average declined by -0.13% per month or by -1.58% annualized.



For each quintile correlation range (from Chart 1), Chart 2 shows the annualized percentage price gain in the U.S. stock market for all months since 1900 when the 10-year U.S Treasury bond yield increased. For example, when the correlation was among the highest quintile readings since 1900, bond yields rose during 127 of those months. During these 127 months, the U.S. stock market increased by an average monthly percentage of 1.63% or at a 21.41% annualized gain. By comparison, when the correlation was in the bottom quintile, there were 128 months since 1900 when bond yields rose and during these months U.S. stocks on average declined by -0.13% per month or by a -1.58% annualized loss.

For all months since 1900, the U.S. stock market has appreciated at about a 5.3% annualized pace. Therefore, even when considering only those months when bond yields have risen, the stock market has surprisingly managed to outpace its overall long-term average gain as long as the correlation between stocks and bond yields was in the top two quintile ranges. In this manner, the contemporary risk stock investors face from rising yields may have less to do with how much they rise or how high they are, as it does with the surrounding attitude of investors concerning inflation / deflation.

Currently, the consensus investor mindset is viewing the recent rise in yields (and Fed tightening) as a positive for the economy and the stock market (as implied by the strong positive correlation in Chart 1). Fears of deflation and anxieties surrounding another potential crisis are beginning to diminish somewhat as commodity prices recover, as U.S. and global economic growth broadens and improves, as the Fed finally begins to normalize monetary policy and as the interest rate structure around the globe moves back above zero. However, as suggested by the top-quintile current historic correlation in Chart 1, the dominant concern remains deflation suggesting rising yields are still "good" for the stock market.

Concluding comments

Our expectation is for inflation fears to escalate yet this year and eventually become the primary focus among most investors. That is, we anticipate the stock-bond yield correlation to ultimately decline and warn that bond yields have finally risen too much for the stock market. But until the attitude among investors does in fact shift from deflation to inflation worries, rising yields and Fed tightening may continue to be met with a resilient stock market. And, as illustrated by Chart 2, if history is any guide, investors may want to remain constructive towards the stock market (at least as long as the correlation remains so strong) even though yields are rising.

While most prepare for a stumble as the Fed lifts the funds rate for a third time this week, investors should at least consider whether they are "ready to R…U…M…B…L…E?"

Thanks for taking a Look!!

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An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.

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