An Interest Rate Indicator Turns Unfavorable For Stocks

The interest rate environment has long been recognized as important to the performance of the stock market. Periods of falling interest rates have generally been more favorable for stocks than periods of rising rates. Here we present an interest rate indicator that has just flashed a warning on stocks.

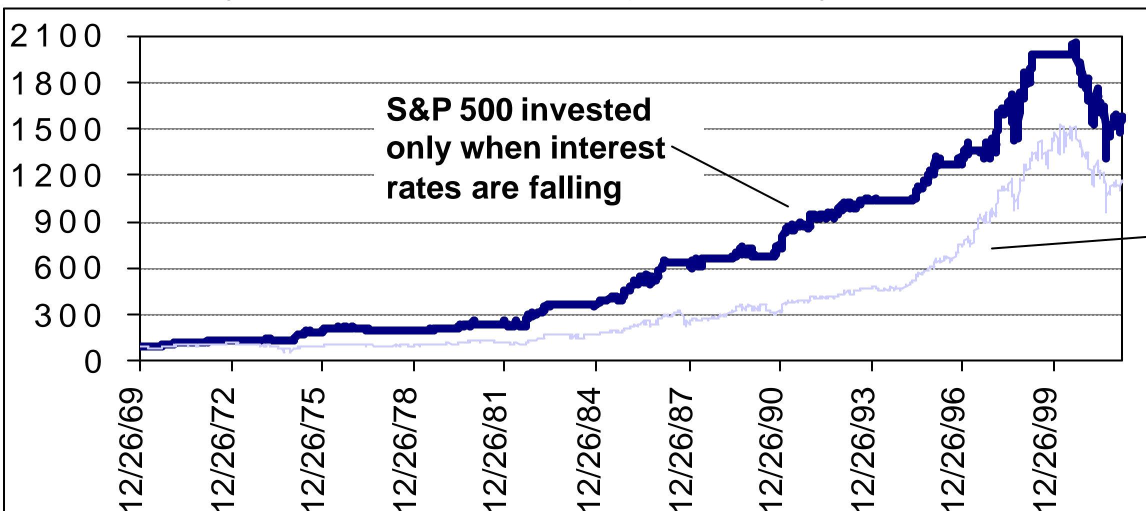
We compute the average of Treasury note yields for two maturities: 3 and 5 years. When this average is higher than it was 33 weeks earlier, rates are rising and the interest rate environment is unfavorable. When the average yield of 3 and 5 year notes is lower than it was 33 weeks prior, interest rates are falling, which has been favorable for stocks. Since 1969 the model has indicated favorable interest rate conditions 53% of the time.

From 1969-2002, the S&P 500 has gained 8.1% per year (excluding dividends). If you had been in the S&P 500 only when interest rates were falling, you would have gained 9.2% per year , or an 18% annualized rate of gain when invested. When rates have been unfavorable, the S&P 500 has lost 1% per year. Investors who exited stocks during unfavorable interest rate climates could have collected interest on cash-equivalent investments.

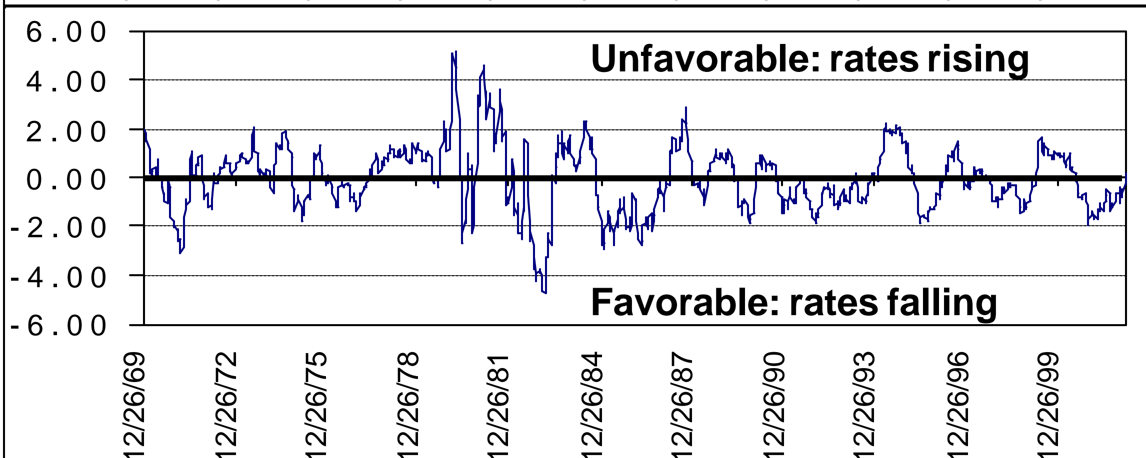
During the 1990's, stocks were less sensitive to interest rates than previously. In particular, the market rose sharply from 1995-1997, even though interest rates were rising a good part of that time. This interest rate indicator had its greatest performance in avoiding much of the 1973-1974 bear market and in exiting the market in July, 1987. While no future performance for this indicator can be assured, it seems reasonable to expect that periods of rising interest rates will usually be associated with a less favorable risk/reward balance in the market, compared to when rates are falling.

Readers should note that while this particular indicator has turned negative, the overall picture remains mixed. Also on the minus side for stocks, our corporate bond model has been on a sell for over three months. However, the flattening yield curve (see page 8) and low short-term interest rates are potentially bullish for stocks.

Since World War II, the U.S. has mostly been in an inflationary environment. However, when interpreting interest rate movements, it is important to beware of unusual periods of threatened deflation, such as the summer of 1998. During such deflationary periods, both interest rates and the stock market would be expected to fall in tandem. As such conditions resolve, rising interest rates would paradoxically represent a sign of economic health.



S&P 500 always invested, no dividends



Equity curves do not take account of dividends, interest earned when out of market, transaction costs or taxes. Results are hypothetical (S&P 500 index fund investments were not available throughout the study period) and unaudited, although believed accurate.