Roughly six months ago, on July 8, 2016, the ten year treasury yield hit a low of 1.36%. From that moment on I believe many things changed. Over the following months, rates steadily rose and hit a high on December 15, 2016, at 2.61%. This is unprecedented: almost a doubling of interest rates over a six month period. Most retail investors had no idea this happened. I think this may be far more significant than the recent rally in stocks due to the outcome of the election. I have always believed that bond yields are the tail that wags the stock market’s dog. Let me explain further. From 2009 until this July, it was perceived by many that the Federal Reserve Bank of the US did anything it could to keep interest rates and volatility low. Stocks love this environment as the indexes showed. Most stocks broadly moved higher through this period in cases due to Price to Earnings multiple expansions (P/E ratio). The main thing you need to understand about a P/E multiple is that normally when interest rates have gone down, P/E ratios have tended to increase and therefore a stock’s price relative to its earnings had tended to go higher. Conversely, in periods when interest rates have gone up, P/E ratios have tended to contract. Therefore, a stock’s prices relative to its earnings have tended to go lower.

I believe we have finally entered a period where the FED cannot and hopefully will not provide any further stimulus. I also would like to believe we can hold the FED to its word this year, unlike last year, and that they will increase overnight lending rates three times, as they have stated. This should cause P/E multiples to contract. Last year, in January, the FED told us they would likely raise overnight lending rates four times, they only did it once. Since markets are anticipatory and many professional investors now believe the FED may do this, as stated earlier, the yield on the ten year treasury rose tremendously. This is very confusing to most retail investors. Most retail investors believe that when the fed raises interest rates all other rates then automatically go up as well in tandem. It very rarely happens that way and instead tends to happen like we just experienced. Traders (investors) tend to bring rates higher before a FED move; selling bonds that they fear will drop in value in anticipation of the FED’s actions. Once the Fed moves, other rates may tend to actually drop a little. For example, the yield on the ten year treasury has now dropped back down to 2.36% as of this writing and much of this drop back down happened after the Fed increased overnight lending rates in December. Again, this can be very confusing to most.

The bottom line take away from this is: Medium term (10 year) interest rates have already gone up tremendously. Earnings growth should now matter a lot more to make a stock go higher, given P/E multiples begin to contract. Stocks that went up due to P/E expansion and not organic earnings growth may have a tough time. All of this may cause more volatility in stock prices than we have recently seen over the past 8 years.

To the investor, what this had meant was that from 2009 till July of 2016, one of the best places to have had all your money was in large cap index funds. As rates went down and P/E multiples expanded most stocks broadly went higher. Any sort of diversification into investments that hedged interest rates moving higher, that traded on volatility, or that shorted lower quality stocks: underperformed. Modern Portfolio theory did not work because, in my opinion, the FED took out most of the market risk and made it easy for companies to borrow money to boost a stock price. Since July, in tandem with the interest rates rise, it would appear that real earnings growth may now matter a lot more to make stock prices move higher.
How I positioned at the beginning of 2016 is what I believe is correct for 2017. I would argue that I was six months too early to the punch and suffered in the first half of last year, when in February, the FED did an abrupt about face and stated they would continue to wait to raise rates any further. From those Fed statements, interest rates nose-dived back down and downside volatility again disappeared. Market indexes rallied back up and most defensive and hedge investments were caught on the wrong side of the trade. The good news is that most investments that were caught off guard by this have corrected for it and have made up most, if not all, the losses temporarily created. Given the FED does not do an abrupt about face again this year and stays true to its word we should see much better performance from investments that benefit from trading volatility, trading on interest rate moves, and trading long and short in equities. I as well believe it will be a much better environment for stock pickers verses indexes. Of course, only time will tell.

What many retail investors did toward the end of last year is throw in the towel. Many sold their bonds, sold their hedged investments, and sold their stock pickers all in favor of index type investments. Chasing the hot dot which has had an eight year Fed induced run may not continue to be a great investment strategy. I worry for them.

There is a lot of change that appears to be on the horizon. I hope much of it will be for the positive for business and the economy and that it will hopefully reflect positively in the markets. I hope we can take the FED’s word this year. I hope Europe can find a better path, as Europe is my greatest economic worry. It is my hope that the new administration will reduce unneeded regulations and taxation and that this will boost GDP. Again time will tell.

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