MarketWatch

When interest rates rise, should you sell stocks?

By Mark Hulbert
Published: Sept 13, 2013 2:26 p.m. ET

Commentary: When investors follow the 'Fed Model'

Rising interest rates aren't a good reason to give up on stocks.

That isn't what many investors believe. Indeed, it is so widely assumed that rising rates will eventually threaten the stock market that few ever stop to analyze the historical evidence.

They simply take for granted that rates usually rise because of higher inflation, and that the combination is bad for stocks.

Yet there is no consistent historical relationship between interest rates and the stock market, says Javier Estrada, a professor of finance at the IESE Business School in Barcelona.

Of course, you might have other reasons to think stocks will find it tough going soon — such as the debt-ceiling fight in Washington, geopolitical uncertainty and the sheer age of the bull market. But you should reconsider your bearishness if it derives solely from concerns that rates will rise.

What does history teach us about the relationship between higher interest rates, inflation and corporate profitability?

Consider inflation's impact on earnings. Cliff Asness, founding principal of AQR Capital Management, an investment firm in Greenwich, Conn., with more than $80 billion under management, analyzed the data back to 1926 and found no statistically significant evidence that higher inflation leads to lower profits.

Still, some investors will argue that even though earnings might rise faster when inflation is higher, stock prices will nevertheless do worse — because inflation also will lead to higher interest rates and cause price/earnings ratios to decline.

This is a core belief of the so-called Fed Model, which holds that P/E ratios should rise as interest rates decline, and vice versa. The strategy got its name in 1997, following a reference in a Federal Reserve report to the tendency of the S&P 500's SPX, -0.23% P/E ratio since the early 1980s to move in the opposite direction of long-term interest rates.

During the 15 years before the Fed made that observation, the U.S. stock market's P/E ratio did indeed tend to be higher when interest rates were low, and vice versa, Estrada concedes. But, he points out, that relationship hasn't held up as well since then, raising the possibility that the apparent correlation might have been just a coincidence.

Further doubts came when Estrada analyzed U.S. experience over the 100 years before 1980, as well as the stock markets of 19 other countries. He found no consistent relationship between P/Es and interest rates.

If the Fed Model were correct, then above-average P/Es would suggest an overvalued market only if rates were high — just as low P/Es would mean the market is cheap only if rates were low.

This isn't what Estrada found across the 20 countries he studied. High P/E ratios were more often than not followed by below-average returns over the subsequent five years, regardless of where interest rates stood — just as low P/E ratios were more often than not followed by above-average returns even when interest rates were high.

AQR's Asness reached a similar conclusion when focusing on returns over the subsequent one- and 10-year periods.

The investment implication: You should resist the temptation to become more tolerant of high-P/E stocks when interest rates are low. By the same token, though, history suggests you don't have to run for the hills now that higher rates appear on the horizon — especially if you avoid overvalued stocks.

There is no exchange-traded fund that focuses strictly on low-P/E stocks, says David Nadig, president of ETF analytics at IndexUniverse. However, he says, several come close, including iShares Morningstar Large-Cap Value JKF, -0.06% , which charges annual fees of 0.25%, or $25 for every $10,000 invested.

There is an exchange-traded note that relies on a modified P/E ratio to determine sector bets: Barclays ETN+ Shiller CAPE CAPE, +0.15% , which uses the cyclically adjusted P/E ratio devised by Yale University Professor Robert Shiller. Its annual fees are 0.45%.

Most investors, though, prefer not to focus only on the P/E ratio, in hopes of avoiding out-of-favor stocks that truly deserve their low valuations. One strategy is to consider only those low-P/E stocks that also are being recommended by advisers with stellar long-term records.

There currently are a handful of stocks with P/E ratios below 12, based on 12-month trailing earnings, which also are popular among those few advisers tracked by the Hulbert Financial Digest who have beaten the stock market over the past 15 years. (The S&P 500's comparable P/E currently stands at 18.6.)

They are insurer Aflac AFL, -1.42% , with a P/E of 8.5; global commercial bank J.P. Morgan Chase JPM, -0.41% , with a P/E of 8.7; Pfizer PFE, -0.20% , the pharmaceutical company, with a P/E of 9.5; oil company Chevron CVX, +0.47% , with a P/E of 10; banking giant Wells Fargo WFC, +1.05% , with a P/E of 11.5; Freeport-McMoRan Copper & Gold FCX, +3.50% , a mining concern, with a P/E of 11.8; and defense contractor Northrop Grumman NOC, +0.67% , with a P/E of 11.9.

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