WELLS CAPITAL MANAGEMENT

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It's not when Interest Rates Rise …. It's when Confidence Falls

U.S. bond yields have risen significantly in the last year, monetary officials have finally begun tapering and expectations about when the Fed will first hike the funds rate are moving closer. These events have understandably combined to focus stock investors on interest rate risk. However, the stock market often does quite well during periods of rising yields provided consumer confidence remains healthy. Despite a year characterized so far by higher bond yields, Fed tapering, discussions of early Fed rate hikes, weak weather-impacted economic reports, and some old school cold war rumbles, consumer confidence rose to its highest level in more than six years in March!

Investors are understandably wondering how much the Fed can tighten and how high bond yields can rise before the stock market begins to struggle. Based on history though, rather than watching the Fed or interest rates, perhaps investors should simply stay focused on confidence.

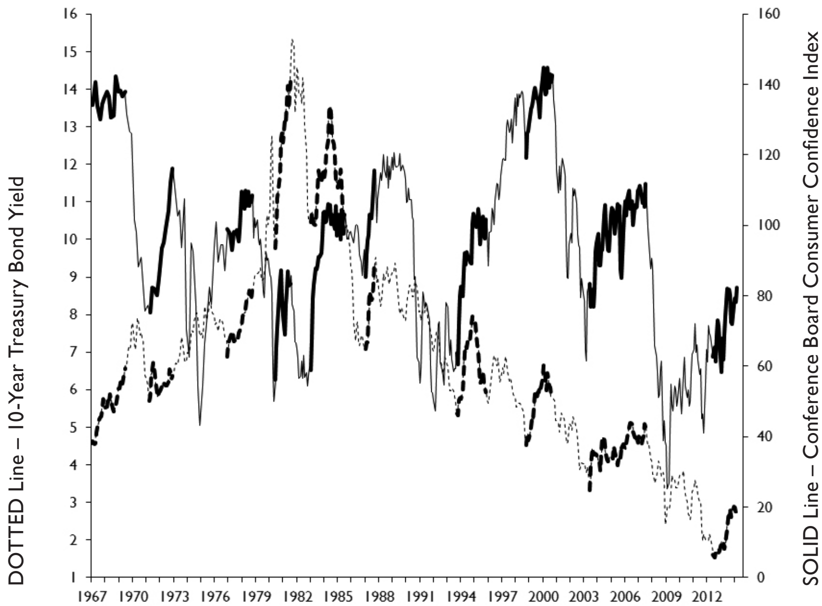
10 Major yield/confidence cycles

Chart 1 highlights 10 major periods since 1967 when the 10-year Treasury bond yield was rising "and" consumer confidence was either rising or holding steady. Each of these cycles is highlighted in boldface on the chart. The solid line represents the consumer confidence index and the dotted line is the 10-year Treasury yield. We define each cycle as initiated when the 10-year bond yield reaches a major bottom and is subsequently ended when consumer confidence begins a major collapse. Chart 2 illustrates the performance of the S&P 500 during each of these 10 yield/confidence cycles. Finally, for each cycle, the date ranges, the performance of the stock market, change in the bond yield, and percentage growth in confidence is specified in Table 1.

As these charts show, the stock market has not typically done poorly when bond yields rise. Each of the 10 cycles illustrated show periods of rising bond yields and only during one entire cycle (December 1976 to October 1978) did the stock market decline. Certainly the stock market has suffered mild corrections when both yields and confidence were rising (e.g., in 1968, 1971, 1978, and 1984) but as long as confidence is solid, higher yields have not been that problematic for stocks. Therefore, despite widespread impressions to the contrary, rising bond yields have usually been associated with "gains" in the stock market because most periods of rising yields are also associated with rising confidence.

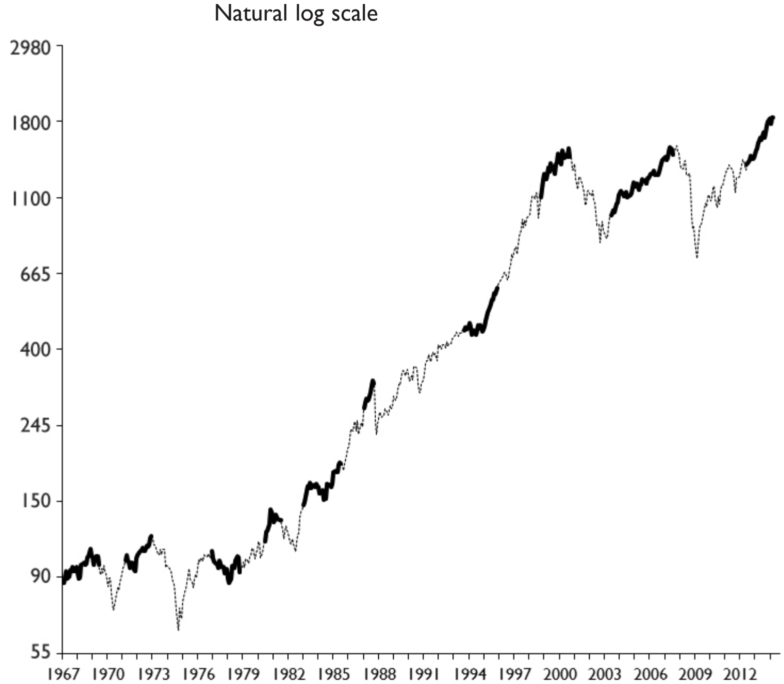
The stock market has suffered major declines during periods of rising yields (e.g., 1970 and 1973-74) but has also experienced big declines when bond yields were falling (e.g., 2000 to 2003 and again between 2007 and 2009). By contrast, the stock market has seldom suffered a major collapse when confidence was steady or rising. And, as these charts illustrate, the stock market has produced positive results in nine of the 10 major upward yield/confidence cycles since 1967. Consequently, stock investors should not myopically focus solely on rising bond yields or on how soon the Fed will begin raising short-term interest rates. Rather following and assessing "confidence" might prove more profitable.

Chart 1: Bond yields and confidence*



*Both series are boldface during 10 major upward yield cycles since 1967. Each cycle is initiated at the low in bond yields and is ended when consumer confidence peaks and begins a major decline.

Chart 2: S&P 500 Stock Price Index**
Natural log scale



**This chart is boldface for the same periods as the other chart based on periods of rising yields & confidece.

Table 1: Yield/confidence cycles

Cycle dates	Percent change in S&P 500	Percentage points change in bond yield	Percent change in confidence index
1/67 to 6/69	12.8	1.99	2.7
3/71 to 12/72	17.7	0.66	54.4
12/76 to 10/78	(13.3)	1.77	9.8
6/80 to 7/81	14.6	4.50	48.8
5/83 to 7/85	31.4	(0.15)	74.9
1/87 to 9/87	17.4	2.34	35.5
10/93 to 11/95	29.4	0.60	67.9
10/98 to 9/00	30.7	1.27	19.5
6/03 to 7/07	49.3	1.67	34.0
11/12 to 3/14	36.9	1.12	31.3

Summary

Yields have started to rise in this recovery and the monetary authorities have begun tapering and will soon ultimately be forced to raise the Fed funds rate. However, these events alone should not be overly damaging for the stock market. So far, the primary reason yields are rising and the Fed is considering monetary policy normalization is because "confidence" in the economic recovery is improving.

Provided confidence continues improving as yields rise, the stock market should keep advancing. Stock investors should stay focused on "why" yields are rising? Is it primarily because of growing and broadening evidence of a stronger and more sustainable economic recovery (a confidence boosting reason)? Or, are yields primarily rising because of concerns about emerging inflation/overheating pressures and concerns surrounding whether the Fed is falling behind the curve (a confidence destroying reason)?

Currently, we think "good news on the economy" is good news for stocks even if it is bad news for bonds. That is, both yields and confidence are rising because of improvement in the economic cycle. We would not be surprised, however, if sometime later this year, good news on the economy becomes bad news for stocks. That is, as we have argued elsewhere, probably from a higher S&P 500 level (2000ish?) and from a higher 10-year bond yield (3.5%ish?) than today, the stock market could suffer a temporary correction as "good news" on the economy begins to hurt confidence by awakening inflation concerns.

Whether the stock market does suffer an "inflation-fear" pause sometime in the next year, the longer-term outlook for stocks remains favorable in our view. Currently, we do not think a sustained inflationary problem is likely in this recovery, and in part because of this belief, we expect the recovery to last several more years. The history of consumer confidence illustrated in Chart 1 shows how much more improvement may still be forthcoming. The confidence index is currently near 80 and historically has peaked in past recovery cycles above 120. The potential for another 50 percent advance in confidence before this recovery ends keeps us long-term bullish on the stock market. As suggested by Chart 1, continued gains in confidence may keep the stock market rising even as bond yields rise further and even once the Fed eventually begins normalizing the Fed funds rate.

Thanks for taking a Look!!