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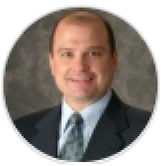
Why An Interest Rate Hike Will Not Stop The Stock Market Rally



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The markets continue to climb a wall of worry with only the spectre of fire and fury from a fierce conflict with North Korea dampening the enthusiasm for stocks. Interestingly, as of August 14th the South Korean stock market, as measured by the KOSPI index, was up over 16% for the past year Source: Bloomberg, indicating at least some belief that conflict will not develop. With the costs of conflicts so high, the odds are for more chatter but (hopefully) no war.

While it seems implausible for stocks to continue to rise after such a historic run up since 2009, the data explains why stocks have been able to defy the emotional worries of a stock market correction, the fears of global instability, and a potential rise in interest rates. Earnings are the biggest determinant of stock prices—not news headlines, nor tweets, nor fears about what might happen. Interest rates matter, but for a variety of reasons, a rapid rate climb is unlikely for the remainder of 2017.

Pedestrians carrying an American flag umbrella pass in front of the New York Stock Exchange (NYSE) in New York, U.S., on Monday, Aug. 14, 2017. U.S. stock-index futures advanced and volatility subsided as an escalation of tensions between the U.S.

To be sure, we see some pressure on rates as a result of stronger economic growth from the U.S. and other major economies; but the stock market also continues to benefit from relatively low and stable oil prices, low inflation, and low interest rates. The Federal Reserve Bank (The Fed) has spoken about slowly unwinding some of its "Quantitative Easing," which could have the effect of raising interest rates—but that is not scheduled to start until October.

One of The Fed's mandates is to control inflation. Currently we don't see any hint of runaway inflation; so The Fed has less pressure to control prices and raise interest rates. The Fed's other mandate relates to employment. We currently have low unemployment and an improving labor market, but since wage growth has only recently ticked up, The Fed is not likely to dramatically change its course at this time.

Yet fear still reigns on Main Street, and investors continue to keep cash on the sideline, hoping to be able to say "I told you so." But with the Dow Jones Industrial Average hovering near 22,000, the market would have to drop 16% to return to Election Day levels. That would almost bring us into bear-market territory (a drop of 20% or more is officially a bear market), yet there is little to indicate that is an immediate threat.

Interest Rates Not Yet A Threat

To be sure, this stock market rally will end, but it will more likely end as a result of low or no growth to corporate profits rather than a bounce in interest rates. Historically, rising interest rates occur during a growing economy, but higher rates do not negatively impact stock prices until the 10 year Treasury rates are in the 4% to 5% range–and that is a range that is unlikely to be seen soon.

In recent months, The Fed and the European Central Bank (ECB) have both stated that they will be selling bonds into the open market, thereby decreasing the available supply of money and potentially raising interest rates. Even though they both emphasized that this reversal of policy will be gradual, the markets reacted (e.g., the Euro rose against the dollar after the ECB announcement). This reactivity to any Central Bank action has the result of slowing down any tightening of monetary policy and underscores the likelihood that any action will be deliberate.

Trump Agenda And Its Impact

At this point, the much ballyhooed Trump agenda hasn't really been the driver of this stock market rally. Congress hasn't passed an infrastructure spending bill, and we haven't had meaningful tax reform.

This would indicate that the market has indeed rallied due to other factors (e.g., earnings).

If we stay away from protectionist trade policies and deadly conflict and if Congress continues with its regulatory reform and passes a tax bill and an infrastructure spending bill, then the economy could surge, justifying current stock market levels. At that point, The Fed may need to act more aggressively—in which case, hikes to interest rates may serve as a headwind against a rise in stock prices. However, that will take Congressional action, which hasn't been easy to come by lately.