MARKET
Insights

Webster Private Bank®

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FOMO

The Fear Of Missing Out (FOMO) seems to motivate investors at this late stage of the rally. Nearly all the world's major stock markets delivered double-digit gains for the year through November 30th, and half of the world's largest stock markets have reached all-time highs this year, according to The Wall Street Journal. In addition, only 13 countries in the world are in the midst of recession. This is the lowest count since 2007, according to the International Monetary Fund.

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The Dow Jones Industrial Average reached an all-time high of 24,327 on Nov 30th and returned **+25.5%** for the year to date. International stocks have recovered from a two-year bear market that began in mid-2014. The MSCI EAFE index of international stocks has returned **+22.6%** in dollar terms for the year. Even bond investors have something to cheer. The Barclays US Aggregate index of investment grade bonds was up **+3.4%** for the year through November. Inflation has remained subdued, with the CPI up only **+2.0%** year over year, despite accelerating economic growth and corporate profits.

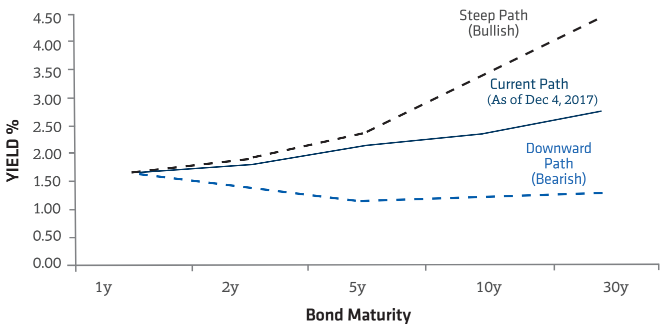
The Path of Interest Rates – What Lies Ahead For Investors

This year's ascent in stock markets is like climbing a mountain without knowing what lies on the other side. The climb has been exciting, with few obstacles so far, but we don't know what risk lies ahead. Much of the rise is due to historically low interest rates. All else equal, an environment of low interest rates makes income from common stocks (which grows over time) more attractive than fixed coupon payments from bonds. The stock market seems to believe that low interest rates, combined with real earnings growth, warrants higher prices for now.

The bond market, however, is not signaling that we should expect much growth from the economy and, hence, our stock investments in the future. This is evident in the difference between long- term and short-term interest rates.

A "steep" path of interest rates is a bullish signal for investors, as future growth is expected to be higher and is reflected in higher future interest rates. A "downward" path is bearish: future interest rates are lower than today, signaling growth is expected to be weaker in the future.

Path of Interest Rates: Steep is Bullish, Downward is Bearish



Source: FactSet Indexes, Dec. 4, 2017. Data for benchmark US Treasury notes and bond.

Today's path of interest rates is somewhere in between bullish and bearish. We focus on the difference between the yields of Treasury ten-year and two-year notes. In recent months, the difference has shrunk, both because short-term rates have risen and long-term rates have fallen. The Federal Reserve raised overnight interest rates twice this year – in March and June. Two-year Treasury note yields increased from **1.26%** at the start of the year to **1.77%** as of November 30th. However, yields on ten-year Treasury notes have fallen this year, from **2.48%** to **2.39%**. Thus, the difference between these long and short term rates has declined from **1.22%** at the start of the year to just **0.62%**.

The shrinking gap between long-term and short-term interest rates may indicate that current monetary policy is too restrictive relative to the market's expectations for future growth. Historically, future stock returns have not fared well when the difference between long- and short-term rates is less than 1%. As the table here demonstrates, the worse returns occurred when the difference was less than 0% (when long-term rates were actually lower than short- term ones).

Difference In Long Term and Short Term Rates	US Stock Market Return (S&P 500)	
(10Y minus 2Y Treasury)	Next 12 months	Next 2 Years
Less Than 0%	-11.6%	-0.3%
Less Than 1%	+4.6%	+2.1%
Greater Than 1%	+12.4%	+12.5%

Source: FactSet indexes, Webster Private Bank calculations. Month end rates and total returns, Nov. 1987-Nov. 2017.

We would remind investors that it is normal for the difference in interest rates to narrow during the middle-to-late stages of an economic expansion. Furthermore, it would take a very bearish catalyst to push the path of interest rates downward (as did the dot-com bust in 2000 and the subprime crisis in 2007). Nothing like those conditions is in place now.

Summing it up

We are mindful that the path of interest rates could steepen further from here (as it did after a series of large Federal Reserve interest rate hikes in 1994). This outcome would be bullish for stocks and bearish for long-term government bonds. We continue to maintain our clients' fixed income allocations with relatively short maturities (i.e., less than 5 years). As discussed last month, we also have avoided interest-rate-sensitive companies in our clients' individual stock holdings, by excluding utilities and underweighting sectors like telecom and consumer staples. We believe maintaining an overall stock bias, with enough short-term fixed income investments as "dry powder," will serve client investment objectives. It will allow us to rebalance into any future market correction, and purchase stocks or bonds at more attractive levels of valuation and income.

TO VIEW A MORE DETAILED DESCRIPTION AND ANALYSIS OF THESE INSIGHTS, VISIT WWW.WEBSTERBANK.COM/PB.

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