QUANTITATIVE ASSET MANAGEMENT, LLC
Investment & Advisory Services

November 26, 2018

Dear Clients,

As promised in our most recent quarterly, we wanted to write an intra-quarter follow-up. The topic of interest rates and their impact on the equity markets was something we wanted to expand upon. With the recent volatility in the markets, it also turns out to be an opportune time to touch base with our clients.

The overall theme of our 3rd quarter letter was the impact of rising interest rates on fixed income investments. In simplistic terms, rising rates and bond prices move in opposite directions, which can cause significant volatility with seemingly "safe" investments. Our goal in this letter, is to focus on rising rates and their impact on the equity markets.

To better understand interest rates and their impact the market, we will look at the basic function of the U.S. Federal Reserve. The Federal Reserve can control money supply through three different actions, one of them being the raising and lowering of interest rates. In short, the Fed can control the amount of money that is supplied to the U.S. economy at any given time. If the Fed feels the economy is slowing, it will reduce rates and, increase the money supply, with the hopes of help stimulating the economy. If the Fed feels the economy is improving, it can tighten Fed policy (increase rates), pull money supply out of the economy, and avoid an out-of-control inflationary environment.

If investors were to reflect upon recent market activity, they would conclude rising rates have a negative impact on stock prices. From the start of September through the end of October, the 10-year Treasury yield rallied 10% and hit a high of 3%, a rate not seen since late 2007. During that same two-month period, the S&P 500 was down 9%. However, if one looks back at previous rising rate environments, any correction has been short-lived. Over time you will see rising interest rates are a net positive for the markets.

According to Vanguard, "periods of rising rates almost always coincide with market gains, even if the move higher in stocks is typically modest." Looking at data covering the past 50 years, which included 11 periods where the Fed raised rates, markets rose in 10 of the 11 periods. The Federal Reserve will tighten policy (raise rates) when the economy is performing strongly and earnings growth is robust, and therefore stocks tend to perform well during those periods.

Investment markets and their pricing reflect investor sentiment and their reaction to today’s news cycle. What markets can’t do is tell you what it going to happen tomorrow or, next week, next month or next year. After the recent market volatility, most investors are asking themselves, “what is next?” We still believe there are great values in the equity markets and even more so with the recent sell-off. We also think there is too much inherent risk in the bond markets. That said, at some point interest rates will continue to rise and the risk/reward of owning equities over bonds will shrink. In our view, any long-term correction in the markets will not happen until earning growth significantly slows and interest rates and bond-like investments provide a return closer to equity rates of return.

As always, if you have any thoughts or questions, we encourage you to send an e-mail or give us a call.

Sincerely,

Jeffrey L. Farni, Sr.

John C. Farni