

VIEWPOINTS: INSIGHT INTO EQUITIES

Equities in a Rising Rate Environment: A Roundtable Discussion

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Introduction – Michael Reilly

With the Fed's first interest rate hike now a fait accompli, conventional wisdom would suggest that equity prices should struggle as upward pressure on interest rates translates into higher discount rates. Yet historical precedent would argue that both inflation expectations and the absolute level of interest rates, coupled with the prospects for corporate earnings growth, are key determinants of the resulting trajectory of stock prices. In the present macroeconomic context, inflation expectations appear well-anchored, particularly in light of the slower global growth environment, and the primary objective of the Fed's rate hike appears to be the normalization of monetary policy following the extraordinary accommodation of the past seven years. Barring a policy "mistake" whereby the Fed's decision to boost rates tips a fragile economy into recession, a U.S. economy that grows at least 2-2.5% per annum – as has generally been the case since the Great Recession – should prove a sufficient macro backdrop for U.S. companies to generate mid-to-high single digit earnings growth (excluding the now volatile energy sector). Naturally, a more severe slowdown in China and the emerging markets economies remain potential risks, but U.S. stocks can remain resilient and even thrive to the extent which the price distortions that have long dominated the risk asset landscape begin to subside.

To assess the potential impact of higher interest rates on U.S. stock prospects, I posed a series of questions to my Equity Group colleagues, who share their insights.

In the event long-term interest rates continue to move higher, how does that change the outlook for equities?

Craig Blum: In an environment of low inflation, we would welcome any trend higher in long rates. We believe that during periods of low and/or falling inflation long-term bond yields tend to be pro-cyclical. That is, higher yields typically coincide with firming economic prospects and a stronger cyclical upturn in consumer and business spending activity. Given that equity prices tend to track corporate profits, we would expect higher long rates to track higher stock prices. Indeed, we've seen just such a pattern over the past year. Lower bond yields have generally occurred alongside higher market volatility, rising macro/geopolitical risks, falling inflation expectations, and less certainty around global growth.

Again, these are market signals telling you that higher long rates are pro-cyclical and are confirming stronger economic prospects.

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Diane Jaffee: I agree. If long-term interest rates are moving higher because the U.S. economy is growing, then the outlook for equities is quite positive. Looking back over decades, when the Fed does raise rates due to a strengthening economy, U.S. equities tend to move higher following Fed Fund hikes.

John Snider: Just to add a bit of color to Diane's point, the historical record shows that how the Fed proceeds with rate hikes is important to the outcome for equities. Since the end of QE3, the Fed has been preparing markets for the first rate hike since 2006. There is strong historical precedent that the outlook for equities depends on whether the Fed is raising rates quickly or slowly. Janet Yellen has emphasized that once the rate hikes begin, they should be done slowly. Such a measured pace would stand in stark contrast to the 2004-2006 cycle in which the Fed raised rates in 17 consecutive meetings.

Of 12 tightening cycles since WWII, five have been of the slow variety. In the other seven, the Fed raised rates quickly. On average, the S&P 500 performed much better during the first year of the slow cycles than during the fast ones. Given that the Fed has promised to be very measured and methodical in their quest this time around and given that we are starting from such a low base, I am not as troubled by interest rates rising this time as I would be if the Fed were ultra-hawkish and rates weren't so low.

Given that we place a heavy emphasis on proprietary bottom-up research in equities investing, how do you take into account the anticipated rise in rates when you analyze a specific company?

Iman Brivanlou: This is a concern in our group given our focus on high dividend stocks, which is an investment universe containing a lot of "bond proxies." Our methodology is to search for the best risk-adjusted valuations. To the extent a company's business is fundamentally adversely affected by interest rate increases (e.g., mortgage REITs, which are essentially levered MBS funds), or the company's balance sheet is exposed or vulnerable, we account for the impact of potential rate movements in assessing the risks associated with that company. Also, it's worth noting that some companies such as banks and business development corporations can actually fundamentally benefit from rising overnight rates.

Craig Blum: As growth investors with a strong bias toward quality, we don't have a large exposure to businesses that are interest rate sensitive. Our portfolio companies tend to be self-funded with strong and growing operating cash flow and little or no debt.

The primary focus of our research effort is around addressable market, long-term share structure, sustainable business model advantage, and valuation. Having said that, we do analyze and model interest rate scenarios for those companies that might experience modest near-term fundamental pressure and/or a shift in sentiment resulting from higher bond yields.

John Snider: As part of our investment process, we run best, base, and worst case scenarios when modeling the financials of prospective holdings. Although the evidence would support a soft landing if the Fed tightens slowly and interest rates increase at a measured pace, we also must be mindful that rates might rise more quickly than anticipated and have a negative impact on the economy. At this point in the cycle our worst case scenario must take into consideration a more dramatic economic slowdown than what would generally be a worst case scenario when we aren't on the precipice of a rate hike. We must be mindful that at times recessions have followed the Fed raising rates, and even though they have telegraphed a slow gradual increase, we must be prepared for a more dramatic slowdown. We generally spend more time on the worst case scenario than on either the base or best case because it is very important to understand what the downside is. Preserving value and protecting on the downside is vitally important.

Chang Lee: Since we look for fast-growing and fully-funded businesses, most of our portfolio companies have unlevered balance sheets and tend to have sizable cash holdings. The increasing cost of debt rarely impacts our companies' ongoing financial and business decisions. Moreover, most of our companies may benefit from higher rates by earning higher interest income on their cash balances.

Many investors view equity valuations as stretched at this point in the cycle. Are you concerned that rising rates may send multiples lower?

Tom McKissick: There's a lot of evidence to suggest that valuations are above the mean, but they are not excessive across the board. Margins at companies are at all-time highs, which is unsustainable. But they aren't as unsustainable as they have been in the past. If rates rise but continue to stay low for a long time, the cost of capital will remain low relative to historical periods, so profitability of companies should be enhanced by that. Also, productivity measures continue to improve and competitive variables for U.S. companies are continuing to get better. But given where valuations are in general, it's important to proceed with caution and look at companies on an individual basis.

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Iman Brivanlou: I would agree that some caution is warranted. It is certainly plausible that as rates rise, equity multiples overall would contract. Broad-market valuation metrics are at near-term highs. The massive QE efforts of global central banks – which have had only modest success in stimulating economic growth – have caused risk-asset pricing to inflate beyond what we believe is warranted by underlying fundamentals. Still, while we see evidence of stretched stock valuations, the pricing distortion in the bond market appears even more pronounced. From a relative standpoint, stocks appear cheap compared to bonds. If interest rates were to normalize, I would expect increased volatility in equity markets. Sectors and stocks that have risen exclusively due to cheap liquidity would become exposed, while those with real pricing power or improving fundamentals would continue to thrive.

Craig Blum: We have some concern around aggregate market valuation over the near-term in light of seven years of economic expansion, near-record profit margins and multiples that have risen from 11.0x in 2008 to 17.5x today. Over the short-term we expect higher volatility as global capital markets continue to process a variety of economic shifts and policy developments. Elevated levels of sovereign debt together with the collapse in commodity prices are resulting in a renewed deflationary wave across emerging markets. A number of market-based indicators suggest economic headwinds just as the Fed deliberates tightening monetary policy. However, there is a fundamental problem with equating Fed tightening as responsible for lower valuations. The real culprit historically has been higher commodity inflation. The Fed typically tightens in order to fend off rising inflation, which is the more toxic development that trips up the business cycle. In that context, then, the current status of oil prices, inflation and the U.S. dollar bear little resemblance to that of prior tightening periods. In fact, investors have never before seen a Fed tightening cycle in the face of a material decline in oil prices and downward pressure on headline CPI, two conditions that exist today. The Fed's hyper-awareness of the lopsided risks to a premature tightening make us confident that a major policy mistake is avoidable in the current period's perfectly wrong setup for a rate hike.

In the event of a series of small rate increases over the next several quarters, which industries should we expect to outperform, and which should we expect to underperform?

Diane Jaffee: In that event, we would expect lower dividend payers or companies that have self-help catalysts to outperform.

Generally, consumer discretionary, financials, and technology companies have lower-than-historical payout ratios, both in terms of earnings and free cash flow. We are also currently overweight industrial companies with company-specific catalysts. Sectors that generally have higher payout ratios may suffer under a rising interest rate scenario. They include: consumer staples, utilities, and telecom stocks, although there are individual companies within those sectors that are attractive from a fundamental perspective.

Iman Brivanlou: Of course, forecasting the near-term performance of industries is largely attempting to predict near-term shifts in investor sentiment – a difficult task. That said, we are seeing valuations close to historical peaks in parts of consumer staples and industrials, so we tread carefully in those areas. From a fundamental standpoint, banks and business development companies would be expected to benefit from a series of small rate increases, and we currently hold a favorable view of both industries. To the extent that the series of small rate increases are coupled with sustained economic growth, housing-related sectors and parts of the energy space could prove attractive as well. Mortgage REITs and utilities would likely underperform, although we have already seen substantial weakness in those areas with the market embedding an increased probability for that scenario.

Chang Lee: As always, companies with pricing power and sustainable competitive advantages tend to outperform the market in the long run. Currently, we expect the technology, healthcare and consumer sectors to outperform sectors with excess capacity, mainly industrials and energy. In particular, we are positive on consumer stocks given healthy retail sales, upbeat consumer sentiment, and improving employment data. Cheap energy prices, steady job growth, higher personal income, and easier lending all set the stage for Americans to buy more in the upcoming months, especially in discretionary areas such as dining out, travel, housing, and home improvement. Historically, consumer discretionary stocks, as well as small- and mid-cap stocks, have been clear winners in periods of U.S. dollar strength.

How far rates ultimately rise hinges in large part on whether the economy continues to strengthen. What kind of results are you seeing at the individual company level? How strong is the recovery?

Tom McKissick: This has been a very weak recovery when you compare it to previous recoveries. Typically the sharper the

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recession the bigger the rebound, and we have been plodding along with moderate growth following a particularly severe recession. We are seeing positive growth and an improving employment picture. And certainly there are companies and industries that are doing better than others. But this is an unusual recovery in that M&A activity is currently above average for this point in the cycle, while growth in capital expenditure is well below what you'd normally see in a recovery. The relatively low level of capital expenditures is one reason corporate margins are so high. Companies aren't making big capital expenditures because of a general lack of confidence in the economic picture and the slowness of the recovery.

Chang Lee: Agreed. Since 2009, the overall domestic economic recovery has been gradual and disappointing. However, we expect it to continue, and are hoping for acceleration. We also expect the current upward trajectory in the economy to last longer than in previous cycles because of the significant slack in the global economy. At the individual company level, we continue to be selective regarding the companies included in our small- and mid-cap growth portfolios. As such, we have seen approximately 20% growth in 2015 and estimated growth of around 18%+ for 2016.

The strong U.S. dollar has been a concern among equity investors. How is a rising dollar impacting your analysis of portfolio holdings?

Diane Jaffee: The rising dollar is impacting multinational portfolio holdings generally within a range of 10 to 15%. When asked if they would prefer a higher or lower Euro or Yen, U.S. companies generally respond that if quantitative easing is enabling these economies to stimulate their GDPs, they would rather take a 10-15% translation hit on an order than not have the order be placed. The China Renminbi defense is more troubling if it means there is a lack of control.

Tom McKissick: We are stress testing our portfolio for different dollar environments to ensure that we are properly positioned. One interesting thing to both note and consider as we look at our holdings is the commodity linkage with the dollar. There is a strong correlation between a strong dollar and weak commodity

prices, and vice versa. If we think the dollar is going to weaken, we'd expect that commodities would strengthen. The commodity decline started to occur as the dollar started to strengthen. So it's important to watch that connection as we consider both strong dollar today and possibly a weaker dollar in the future.

John Snider: I think there are two questions to answer here. How does the strong dollar impact the economy and how does the strong dollar impact the stock market and our portfolio? The rise in the dollar index is definitely good for the consumer, which is two-thirds of GDP. It is good for companies importing raw materials and intermediate goods because it allows them to buy foreign goods and services (like traveling as an example) cheaper. And, as Tom noted, it also helps to put downward pressure on commodities like oil as they are denominated in U.S. dollars. A strong dollar, on the other hand, may be detrimental for exporters or multinational companies who derive significant revenues in non-dollar currencies. It does depend on whether there is a gradual appreciation in the dollar or an abrupt change in the exchange rate. The former usually reflects the strength in the economy and allows for companies to plan for a strengthening dollar so the impact will be mitigated and in some cases it is positive. However a sudden rise in the dollar for those companies that are impacted by this change can be quite harmful to revenues and profits because these companies cannot change their cost structure quickly enough to compensate. A stronger dollar has hurt American exporters and in some cases dampened their investment plans for the upcoming year.

Craig Blum: Beginning earlier this year, we began analyzing in detail each company's revenue and profit exposure to non-U.S. markets. We also performed a best efforts analysis around how each company thinks about and hedges its non-U.S. exposure. Our conclusion is that while the significant strength in the U.S. dollar is certainly constraining reported top-line growth, we have all the necessary tools to properly evaluate true organic growth and earnings power underneath the accounting headache. Fortunately, the equity market has also generally looked through most of the dollar-related hit to growth and has more often than not properly responded to fundamental strength that exceeds "currency neutral" expectations.

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