Rochester Financial Services

Fee-Only® Financial Management Services

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Gold	Crude Oil
26,403	2,926	7,963	1,495	1.51%	5.79%	$1,539	$54.72

Investment Strategy Report

Are Low Interest Rates Good or Bad For Stocks?

While August got off to a rough start, and volatility continued throughout, a strong final week erased much of the losses, leaving the month only moderately lower. The S&P 500 and the Dow lost about 1.6% and the Nasdaq about 2.6%. The small cap Russell got hurt the most, losing 5.1%.

But at times, it seemed like it was going to be a lot worse. The month began with the Dow losing 280 points on Aug. 1st, followed by drops of 767 points (Aug. 5), 390 points (Aug. 12) and 800 points (Aug.14). At its low on Aug. 14th, the Dow was down 5.2% for the month. Most of the volatility could be chalked up to uncertainty on the trade war with China, as tough talk by President Trump on one day was following by optimism the next. The markets didn't know how to react, so they decided to churn up and down. The light trading volume during the dog days of summer didn't help.

The good news for stock market bulls is that it appears that while Trump wants to be tough on China, even if it causes short term harm to our economy, he also doesn't want a declining stock market. So just when things looked bleak, he would come out with a tweet about some positive developments on trade talks. Trump's support along with a basically fundamentally sound economy seem to be propping up the market.

But one thing that is spooking investors is the significant drop in interest rates we have seen thus far this year. 2019 started out with US Treasury rates at 2.97% (30 yr), 2.66% (10 yr), 2.50% (2 yr), and 2.42% (3 mo). They have declined steadily throughout the year, and by the end of July, they had dropped to 2.02% (10 yr), and 2.53% (30 yr). However, the decline accelerated during August. For the first time in history, the 30 year bond yield dropped below 2% to 1.96%. And the 10 year yield now stands at 1.51%, approaching its all time low. Most investors associate low interest rates with a slowing economy and a potential recession.

Even more concerning to investors is that not only are interest rats plunging, but the yield curve is very much inverted. I have talked about this before, but with the 3 month Treasury yield now at 1.99%, it is almost 50 basis points above the 10 year yield. It is also now higher than the yield on the 30 year bond.

Optimists like me can come up with several less-than-dire reasons for what is going on in the bond market. To begin with, the Federal Reserve is being too restrictive, setting the current Fed Funds rate at 2.25%. This policy has a) kept the 3 month yield artificially high and b) pushed down the yield on longer term securities because a high Fed funds rates has a restrictive effect on the economy. Another reason that rates have come down is because money is flowing into our bond market from overseas. The yield on the German 10 year bond is currently at minus 0.7%! Those investing $10,000 in a 10 year German bund are guaranteed to lose $70 a year. Pretty incredible. There is currently approximately $16 trillion of negatively yielding bonds world wide. It is no wonder that foreigners are pouring money into US bonds, pushing down the yields.

It is very understandable that investors are concerned about the low interest rates and the inverted yield curve. But like everything else in this business, there is never a clear road map for future market direction. The current dividend yield of the S&P 500 is 1.92%. That is approximately 40 basis points higher than a 10 year Treasury. And if interest rates were to rise, investors in Treasurys would stand to lose money. Louis Navellier wrote in this past Friday's update that "the S&P 500 continues to yield more than the 10 yr Treasury. Folks, that remains a screaming buy signal. The stock market has only yielded more than the 10 yr Treasury 8 times in the past decade. Every single time, it has represented a great buying opportunity". I will also add that after the rocky month we just had, investors are nervous and sentiment is decidedly negative. This is another positive for stocks. Let's see what happens when investors come back from vacation this week. *Jeff Feldman*

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