

HOW INCREASING INTEREST RATES AFFECT EQUITY RETURNS

Alejandro Saltiel – Head of Indexes, U.S.
05/11/2018

Since last September, the yield on the [U.S. 10-Year Treasury](#) has steadily increased from 2.05%, eventually surpassing the important psychological level of 3%.¹ While we’ve written recently about the [implications of rising rates for fixed income investors](#), we believe it is important to understand the consequences this has for equity investors too.

Rising [interest rate](#) periods are often associated with a more positive view on economic growth. As a result, [cyclical sectors](#)—such as Consumer Discretionary, Industrials and Financials—tend to outperform during periods of rising interest rates. Similarly, falling interest rates are associated with a slowdown in economic growth. Defensive sectors—such as Consumer Staples, Utilities and Health Care—fare better when rates are falling.

Defining rising and falling interest rate periods by looking at trends in the moving averages for the U.S. 10-Year Treasury yield² allows us to see how sectors typically behave during the different regimes. The table below shows how different sectors within the [MSCI USA Index](#) performed over the past 20 years. We can see that equities in general performed better when rates were rising. We can also see that [defensive sectors](#) outperformed during falling rate periods, while cyclicals outperformed when interest rates rose.

MSCI USA Sector Indexes in Interest Rate Regimes			
Sector	Falling Rates	Rising Rates	Full Period
Cons. Discretionary	-4.02%	23.78%	7.56%
Cons. Staples	5.08%	6.78%	5.84%
Energy	-8.37%	28.67%	6.67%
Financials	-6.40%	17.25%	3.53%
Health Care	4.02%	10.99%	7.09%
Industrials	-5.64%	24.21%	6.72%
Info. Technology	-6.24%	28.09%	7.81%
Materials	-11.20%	30.99%	5.68%
Real Estate	2.22%	10.36%	5.79%
Telecom. Services	-2.73%	3.78%	0.13%
Utilities	5.30%	4.80%	5.08%
MSCI USA	-4.26%	19.80%	5.85%

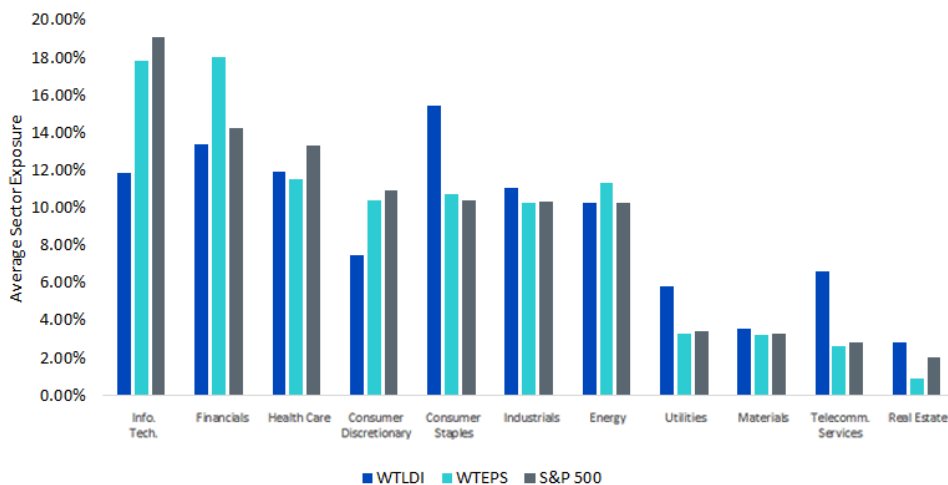
Sources: WisdomTree, FactSet. For the period 3/31/1998–3/29/2018. Past performance is not indicative of future results. You cannot invest directly in an index.

More than 11 years ago, WisdomTree pioneered [fundamentally weighted](#) indexes by launching

its U.S. [dividend](#)- and [earnings-weighted](#) Index families. Once a year, WisdomTree’s U.S. dividend-weighted Indexes will weight dividend payers by their aggregate share of indicated dividends to be paid. Likewise, the U.S. earnings-weighted Indexes are reconstituted annually, weighting companies with positive earnings by their proportionate share of total aggregate earnings. Companies with greater earnings generally have larger weights in the Index. Both dividend- and earnings-weighted families have a total market version along with [large](#)-, [mid](#)- and [small-cap](#) size cuts.

By construction, fundamentally weighted indexes show specific characteristics that deviate from traditional [market cap-weighting](#) benchmarks. For example, the [WisdomTree U.S. LargeCap Dividend Index \(WTLDI\)](#) has a higher aggregate dividend yield than the [S&P 500 Index](#) and has been over-weight in defensive sectors. The [WisdomTree U.S. Earnings 500 Index \(WTEPS\)](#) has a lower [price/earnings ratio](#) than the S&P 500 Index and has had a higher exposure to cyclical sectors. The chart below shows the difference in average sector exposures over the past 11 years.

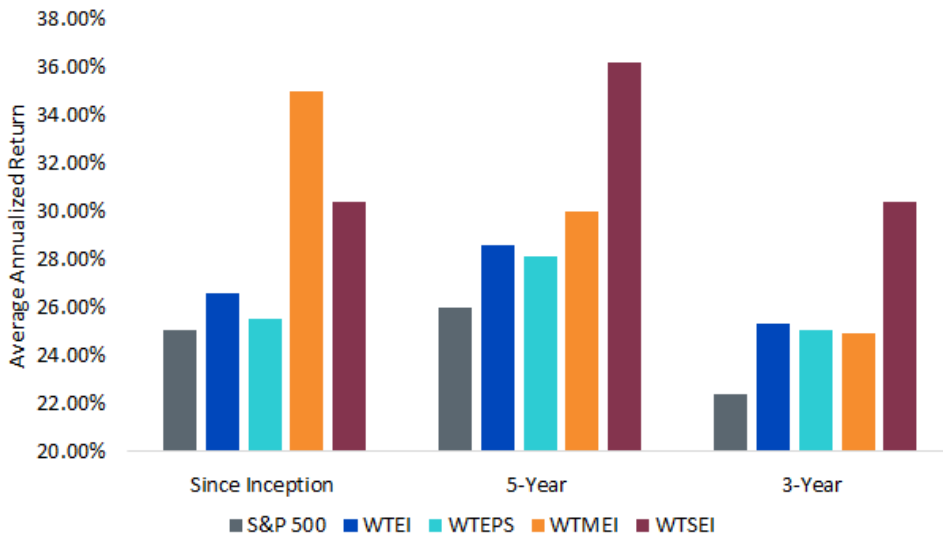
Average Sector Exposure



Source: WisdomTree. For the period 1/31/07–3/29/18. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

These characteristics can help explain performance during different macroeconomic regimes. Below, we focus on how wisdomTree’s U.S. earnings family—consisting of the [WisdomTree U.S. Total Earnings Index \(WTEI\)](#), the [WisdomTree Earnings 500 Index \(WTEPS\)](#), the [WisdomTree MidCap Earnings Index \(WTMEI\)](#) and the [WisdomTree SmallCap Earnings Index \(WTS EI\)](#)—has performed when interest rates rise across different time periods.

WisdomTree U.S. Earnings Family: Returns When Interest Rates Rise



Source: WisdomTree. Since inception period: 1/31/07–3/29/18; 5-year period: 3/31/13–3/29/18; 3-year period: 3/29/15–3/29/18. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

Additional Index information available [here](#).

Looking at the chart above, we can see that all members of wisdomTree’s U.S. earnings family have performed better than the S&P 500 Index when interest rates rise, regardless of the time period. It is also worth noting that the MidCap and SmallCap Earnings Indexes have had a higher outperformance.

The last time the market experienced a rise in interest rates comparable to what we’ve seen so far this year was in 2013, when the yield on the U.S. 10-Year Treasury increased 117 [basis points \(bps\)](#) from April through December. During this period, wisdomTree’s MidCap and SmallCap Earnings Indexes outperformed the S&P 500 Index, which rose 20.21%, by 378 and 954 bps, respectively. If interest rates continue to trend higher, exposure to the [WisdomTree MidCap Earnings Fund \(EZM\)](#) and the [WisdomTree SmallCap Earnings Fund \(EES\)](#), which track WTMEI and WTSEI, respectively, could be a good addition to the equity portion of your portfolio.

¹Source: Bloomberg. Data as of 5/8/18.

²We are defining rising and falling interest rate months using trends in the 50-day simple moving average for USGG10YR and confirming the classification looking at trends in the 50-day and 100-day centered moving averages.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

DEFINITIONS

10- Year Treasury: a debt obligation of the U.S. government with an original maturity of ten years.

Interest rates: The rate at which interest is paid by a borrower for the use of money.

Cyclical sectors: Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

MSCI USA Index: is designed to measure the performance of large and mid cap segments of the US market.

Defensive sectors: Consumer Staples, Health Care, Telecommunication Services and Utilities.

Fundamental weighting: A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

Dividend weighted: Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

Earnings-weighted: Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

Large-Capitalization (Large-Cap): A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Mid-Cap: Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

Small caps: new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Market capitalization-weighting: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Basis point: 1/100th of 1 percent.