

# HOW INCREASING INTEREST RATES AFFECT EQUITY RETURNS

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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%.<sup>1</sup> 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 yield<sup>2</sup> 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%
<b>MSCI USA</b>	<b>-4.26%</b>	<b>19.80%</b>	<b>5.85%</b>

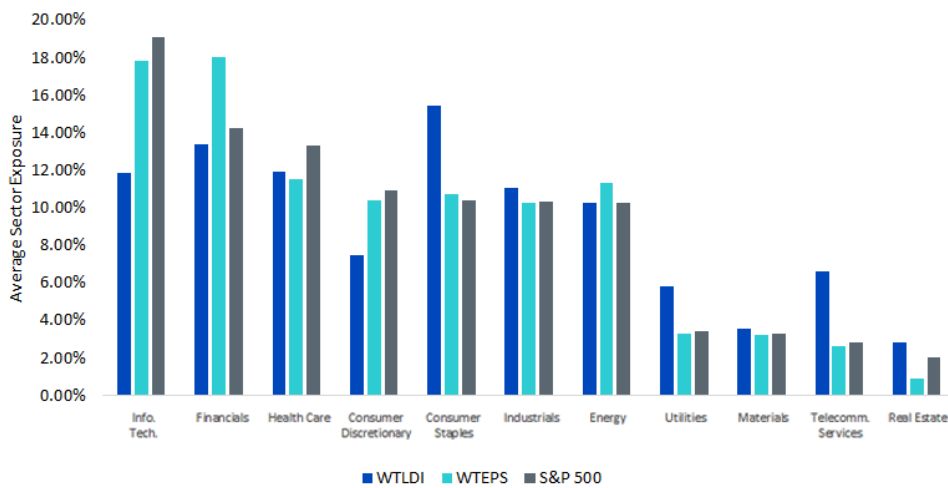
Sources: WisdomTree, FactSet. For the period 3/31/1998–3/29/2018. Past performance is not indicative of future results. You cannot invest directly in an index.

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.

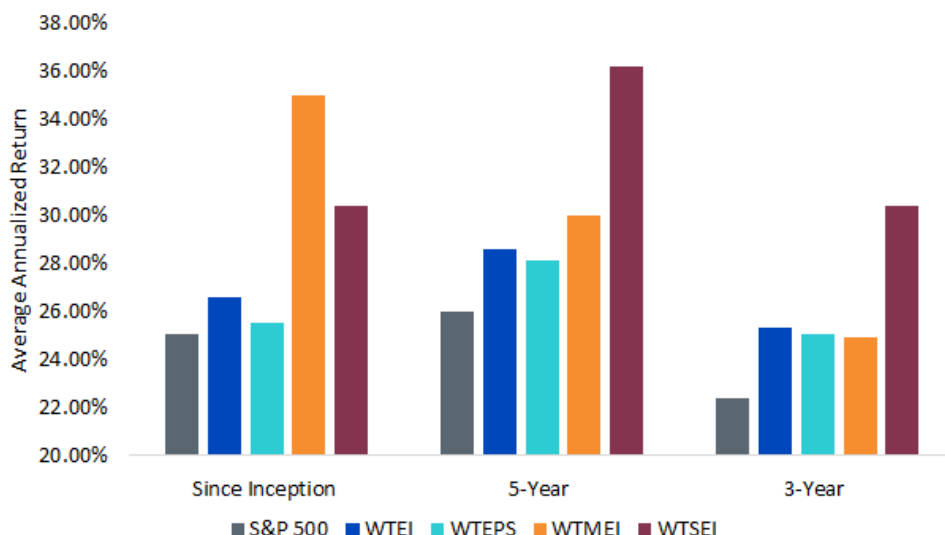
**Average Sector Exposure**



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.

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

<sup>2</sup>We 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.

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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.

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## 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.