Provisus Wealth Management

SEPTEMBER 2014

MONTHLY INSIGHT

RATE HIKES & THE STOCK MARKET

"The data confirms that stock markets have continued to appreciate for extended periods after an initial central bank interest rate hike."

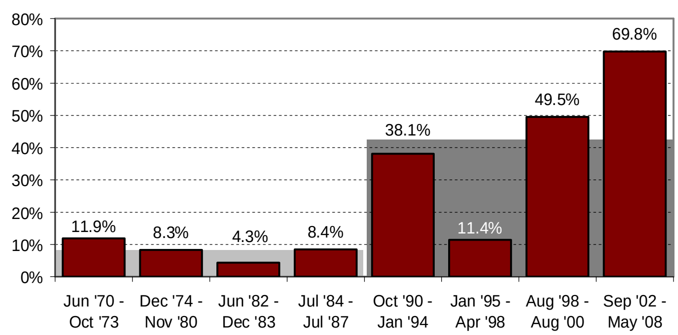
Historically there has been a strong inverse relationship between interest rates and stock prices. Specifically, whenever interest rates rise, stock prices eventually fall and investors are worried that a rate hike is long overdue. But equity bull markets do not end after the first rate hike. The data confirms that stock markets have continued to appreciate for extended periods after an initial central bank interest rate hike. In fact stocks peak and roll over well after rate hikes have begun.

When central banks raise rates there is a reduction in the amount of money in circulation which makes borrowing more expensive. The initial result of a higher bank rate is that commercial banks increase their rates for borrowing money. Individuals are affected through mounting credit card and mortgage rates which decreases the amount of money they have to spend. Businesses are affected as they also borrow money to run and expand their operations so they have less to spend and grow the company which results in less profitability. This of course makes the stock market a less attractive place for investors which ultimately leads to reduced stock prices.

The Bank of Canada (BOC) has kept it's benchmark overnight interest rate at 1.0% since September 2010 but is widely expected to reverse its history making effort to hold down yields in the foreseeable future. Investors are antsy about the timing of the rate hike and the implications for the market even though a BOC bank rate increase does not have a direct impact on stock prices.

No one can accurately predict a market top or correction. There are many reasons for stocks to drop in a rising interest rate environment and all of these factors are interrelated. As the chart to the left and data to the right shows, markets continued to appreciate after an initial interest rate hike. Looking at eight Canadian stock market recoveries since 1970 (with the exception of the recovery from May 1988 to August 1989 which did not include an interest rate hike so it was not included) there are two distinct periods, from 1970 to 1989 and from 1990 to 2008, as reflected by two factors; the time interval between the initial rate hike and the next stock market decline, and the amount stocks rose over that interval. Over the entire 38 year history stocks continue to gain on average for 12 months after the initial rate hike and gained 25.2%. However these numbers are highly skewed by the four most recent recoveries when the average time interval from rate hike to market decline was 20 months, versus 5 month in the first period, and an average gain of 42.2%, versus 8.2% gain in the first period. It is not clear why there is such a pronounced difference but the first interval was subject to high inflation which could be a factor. These distinct periods are emphasized by two different shades of grey in the chart and table. Clearly investors should be hoping that the nearer term history is more likely to repeat itself.

The direction of interest rates is extremely important when considering economic growth and predicting equity prices but it is by no means the only one. While a rising interest rate environment may not be detrimental to equity market returns initially, there is no disputing the ultimate outcome. Despite this outcome there are many defensive stocks and measures that can be taken to mitigate a downturn and it comes down to acting appropriately as new information presents itself.



This chart shows eight Canadian stock market recoveries since 1970 and the amount stocks rose over after an initial rate increase by the Bank of Canada. The average gain was 25.2% but these numbers are skewed by the four most recent recoveries between 1990 and 2008 when the average gain was 42.2% versus an 8.2% gain for the four periods between 1970 and 1989 . These periods are emphasized by the different shades of grey.

Period of Cdn Rallies / Month of Rate Hike	Months to Mkt. Decline
June 1970 to Oct 1973	
April 1973	6
Dec 1974 to Nov 1980	
August 1980	3
June 1982 to Dec 1983	
June 1983	6
July 1984 to July 1987	
April 1987	3
Average	**5**
Oct 1990 to Jan 1994	
February 1992	16
Jan 1995 to Apr 1998	
July 1997	9
Aug 1998 to Aug 2000	
November 1999	9
Sept 2002 to May 2008	
September 2004	44
Average	**20**

This table shows the time interval between an initial central bank rate hike and the next market decline. Over the 38 year period stocks continued to gain on average for 12 months but more recently the markets continued to climb for an average of 20 months.

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MARKET DATA
31 AUGUST 2014

Index Total Returns (%) (C$)

	1 Month	1 Year	5 Years
S&P TSX	2.1	27.1	10.7
S&P TSX Equity Income	2.7	23.5	17.6
S&P TSX Small Cap	2.5	28.2	11.8
S&P TSX Preferred Shares	0.7	6.6	5.0
S&P 500	3.8	29.5	17.6
Russell 2000 (US Small Cap)	4.7	20.3	16.4
MSCI EAFE	-0.3	21.0	9.6
MSCI World	2.1	25.9	13.8
MSCI Europe	-0.1	18.7	6.5
MSCI Asia	-1.5	18.2	5.1
MSCI Emerging Markets	2.2	21.6	6.4

Currencies: (%) (C$)		1 Month	1 Year	5 Years
	US$	0.2	-3.1	0.2
	EURO	-2.0	2.7	-2.0
	GBP	-1.8	10.0	0.2
	YEN	-1.6	-1.8	-2.6

Bond Total Returns (%) - DEX Indices

	1 Month	1 Year	5 Years	Yield
Universe	1.1	7.6	5.2	2.33
Short Bonds	0.2	3.3	3.0	1.59
Mid Bonds	1.0	8.3	6.0	2.39
Long Bonds	2.3	13.6	8.3	3.33
Federal Bonds	0.9	5.5	3.9	1.69
Provincial Bonds	1.5	10.1	6.3	2.72
Corporate Bonds	0.8	7.5	6.1	2.70
Real Return Bonds	0.5	11.8	7.2	0.49
91 Day T-Bills	0.1	0.9	0.8	0.93
Barclays Aggregate Bond (US$)	0.8	5.3	4.4	

Commodities: (%) (US$)		1 Month	1 Year	5 Years
	Index	-1.6	-5.2	2.6
	Oil	-2.2	-10.3	6.7
	Gold	0.3	-3.0	6.3
	Wheat	-3.7	-15.1	4.3

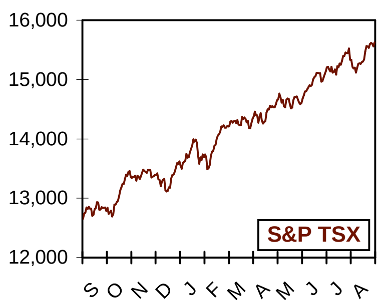
Sector Returns (%)

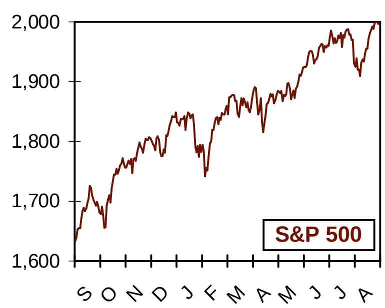
	S&P TSX (C$)				S&P 500 (US$)				MSCI EAFE (US$)			
	1 Month	1 Year	5 Years	Weight	1 Month	1 Year	5 Years	Weight	1 Month	1 Year	5 Years	Weight
Consumer Discretionary	6.2	28.7	15.4	4.7	4.3	18.6	21.5	12.5	-0.9	6.1	9.5	11.7
Consumer Staples	2.1	23.6	16.2	2.6	4.5	14.4	12.7	9.4	1.4	9.3	10.4	10.8
Energy	2.5	26.0	4.5	27.6	1.3	19.7	12.7	10.4	0.7	12.7	2.4	6.8
Financial Services	0.1	24.1	8.1	34.4	3.5	18.9	9.6	15.2	0.7	11.0	1.8	25.5
Health Care	6.0	15.7	25.5	2.5	4.3	29.2	17.3	14.5	3.3	20.9	11.5	11.0
Industrials	3.4	42.7	17.3	8.2	3.9	21.6	16.3	10.8	0.6	10.1	6.9	12.9
Information Technology	1.1	24.5	9.4	1.9	3.2	30.4	15.6	18.6	0.5	18.2	3.8	4.8
Materials	0.3	8.0	-1.5	12.4	3.4	24.7	12.2	3.5	-0.9	8.9	2.6	7.8
Telecommunication	1.6	12.3	10.3	4.3	-1.8	6.0	8.6	2.3	-0.6	14.8	4.4	4.7
Utilities	1.9	12.0	4.8	1.4	3.7	15.2	8.1	2.8	0.9	17.1	-3.4	4.0
Growth Index	3.1	28.1	6.9		3.8	24.5	15.7		0.0	11.7	6.8	
Value Index	0.5	20.8	7.6		3.0	19.1	12.9		-0.8	15.0	3.4	

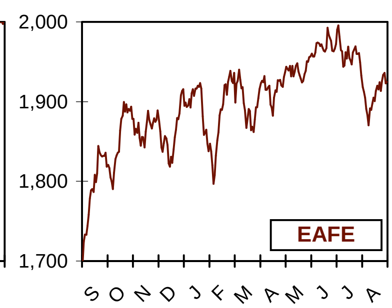
Index Charts

12 Months ending August 2014

Grey shaded areas indicate periods of stock index decline.







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