Winners And Losers From Higher Short-Term Rates

Anyone who has been around the block in financial markets learns the obvious trade seldom is the most rewarding. An important caveat, of course, is contrarian thinking does not produce automatic wins; it simply produces nonstop braggadocio when it does. Some form of Darwinism should have eliminated the contrarian gene from our midst by now as the rest of society went on a rampage it knew to be wrong but felt good nevertheless.

So saying, the obvious trend of expecting short-term interest rates to rise is a compelling one. For starters, the real yield on a two-year Treasury note is -1.25% at the time of this writing; it is maintained there by the combination of a still-accommodative monetary policy and continued risk-aversion amongst a large segment of the investing public.

Dial T For Taper

We saw three taper-related jumps in the two-year note's yield in 2013, one during the May-June first hint, one during the August-September expectation of an announcement and the third and smallest one in December just prior to the actual announcement of the first tapering. The high in yields of 0.534% in early September would not qualify as much of a high at all in normal times.

The two-year note's ups-and-downs did provide us with data as to which industry groups can be expected to out- and underperform the broad market if and when yields move higher. The first table below lists the S&P 1500 industry groups hurt most by rising short-term rates at a 90% confidence level; their weight in the index is multiplied by their relative performance beta to two-year Treasury yields to produce the weighted beta.

	SPR Weight	TU Beta	Weighted Beta
Pharmaceuticals	5.42%	0.015	0.0008
Household Products	1.91%	0.029	0.0005
Electric Utilities	1.63%	0.033	0.0005
Integrated Telecommunications	1.92%	0.024	0.0005
Specialized REITs	1.02%	0.037	0.0004
Packaged Foods	1.48%	0.025	0.0004
Multiline Utilities	1.08%	0.030	0.0003
Hypercenters & Superstores	0.97%	0.030	0.0003
Tobacco	1.37%	0.021	0.0003
Retail REITs	0.63%	0.043	0.0003
Soft Drinks	1.68%	0.016	0.0003
Restaurants	1.33%	0.016	0.0002
Residential REITs	0.38%	0.049	0.0002
Drug Retailers	0.74%	0.020	0.0001
Office REITs	0.26%	0.035	0.0001
General Merchandise Retailers	0.42%	0.020	0.0001
Healthcare Distributors	0.51%	0.016	0.0001
Air Freight & Logistics	0.76%	0.010	0.0001
Gold	0.08%	0.082	0.0001
Gas Utilities	0.27%	0.022	0.0001
Insurance Brokers	0.34%	0.018	0.0001
Diversified REITs	0.17%	0.033	0.0001
Automotive Retailers	0.35%	0.014	0.0000
Food Distributors	0.15%	0.021	0.0000
Industrial REITs	0.11%	0.022	0.0000
Divers Supp Svc	0.12%	0.011	0.0000
Water Utilities	0.03%	0.033	0.0000
Brewers	0.06%	0.015	0.0000
Total:	25.20%		-0.58%

Please note the large number of REITs in this table. This is unchanged from August. Utilities do not fare well, either, nor do consumer staple stalwarts in the packaged foods or hypercenters group; this last one is a fancy term for Wal-Mart (WMT) and Costco (COST). The low ranking of the pharmaceuticals group is more of a function of its large weight than of its negative beta.

What about the groups whose relative performance increases when short-term rates rise? Presumably, these are more economically sensitive than those seen in the table above and they are. They also include a very strong weighting in financial stocks such as Other Diversified Financial Services, home of Bank of America (BAC), Citigroup (C) and J.P. Morgan Chase (JPM). The industrials, energy and technology sectors are represented heavily here as well.

	SPR Weight	TU Beta	Weighted Beta
Other Diversified Financial Services	2.97%	0.039	0.0012
Regional Banks	1.52%	0.040	0.0006
Integrated Oil & Gas	4.23%	0.013	0.0006
Oil & Gas Exploration	2.41%	0.020	0.0005
Oil & Gas Equipment	1.58%	0.029	0.0005
Multisector Holdings	1.19%	0.037	0.0004
Diversified Banks	1.64%	0.026	0.0004
Investment Banking & Brokerage	0.90%	0.047	0.0004
Life & Health Insurers	1.00%	0.041	0.0004
Asset Management & Custodial Banks	1.37%	0.029	0.0004
Industrial Conglomerates	2.28%	0.013	0.0003
Movies & Entertainment	1.61%	0.013	0.0002
Industrial Machinery	1.20%	0.018	0.0002
Construction & Farm Machinery	0.94%	0.017	0.0002
Electrical Components & Equipment	0.82%	0.017	0.0001
Multiline Insurers	0.71%	0.020	0.0001
Hotels	0.30%	0.031	0.0001
Oil & Gas Drilling	0.37%	0.023	0.0001
Semiconductor Equipment	0.31%	0.020	0.0001
Construction & Engineering	0.25%	0.025	0.0001
Commodity Chemicals	0.22%	0.027	0.0001
Electronic Equipment & Instruments	0.23%	0.025	0.0001
Electronic Comp	0.26%	0.022	0.0001
HR & Employment Services	0.15%	0.027	0.0000
Building Products	0.18%	0.020	0.0000
Trading Companies	0.27%	0.014	0.0000
Electrical Equipment Manufacturing	0.13%	0.022	0.0000
Office Electronics	0.09%	0.032	0.0000
Consumer Electronics	0.06%	0.037	0.00%
Real Estate Services	0.06%	0.037	0.0000
Advertising	0.16%	0.012	0.0000
Aluminum	0.07%	0.028	0.0000
Technology Distributors	0.12%	0.015	0.0000
Office Services & Supplies	0.07%	0.026	0.0000
Tires & Rubber	0.03%	0.030	0.0000
Real Estate Development	0.00%	0.031	0.0000
Total:	29.70%		0.74%

The implications are clear: If short-term interest rates rise in 2014 – and even if the contrarians are right, how much can they fall? – you want to tilt away from allegedly defensive utility, healthcare and consumer staples issues and toward industrial, energy and technology issues. Sometimes things can be surprisingly simple if we let them be simple.