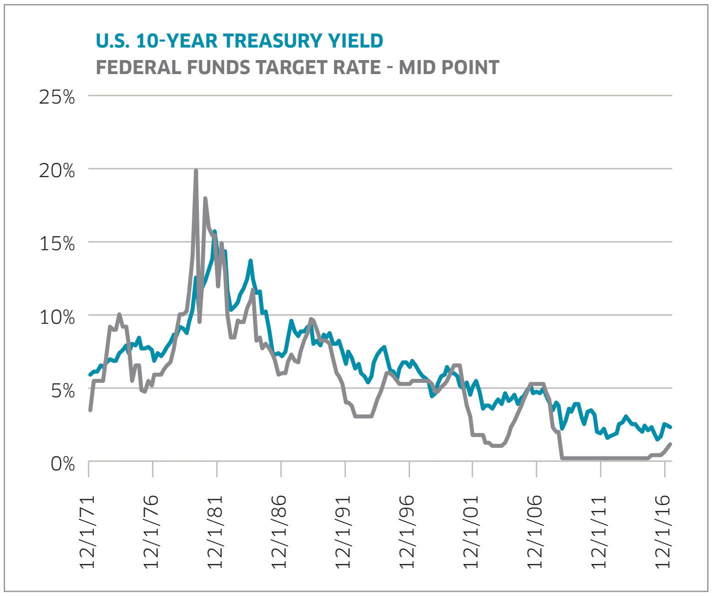
Equity Investing for a Rising Rate Environment

Eight years on from the depths of the financial crisis, the defining characteristic of the global economic recovery remains the extraordinary monetary policies enacted by major central banks. One of the most conspicuous manifestations of this policy framework has been the targeting of the Federal Funds rate at historically low levels. Now that the Federal Reserve has shifted towards a normalization of monetary policy through periodic increases in the Federal Funds Rate, the U.S. economy is poised to face an environment of rising interest rates for the first time in well over a decade. There remains vigorous debate as to how rising rates will impact the broader economy, but from a capital markets perspective, the winners and losers in periods of rising interest rates have tended to cluster on the basis of sector classification.

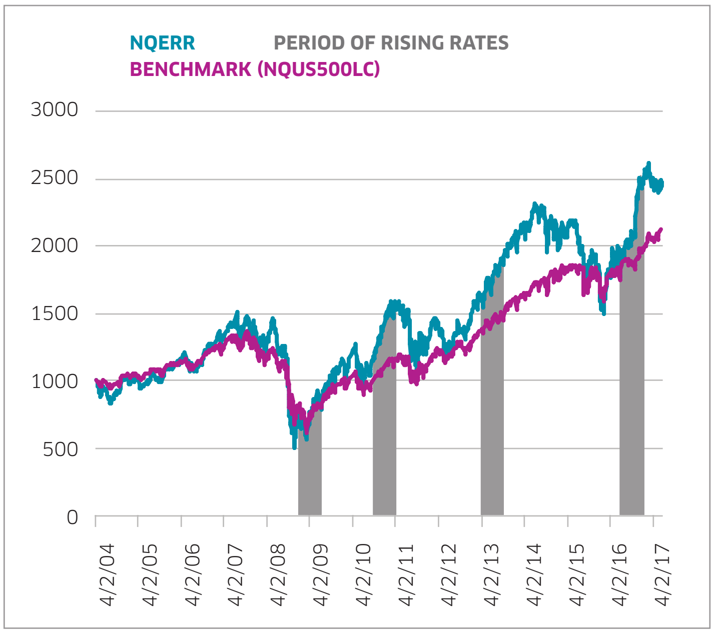
The Nasdaq US Large Cap Equity Rising Rates Index (NQERR) aims to select stocks that are well-positioned to outperform in periods of rising interest rates. The index first identifies the five sectors that have exhibited the highest near-term correlation to movements in the U.S. 10-year treasury yield, which serves as a widely-tracked benchmark for other interest rate markets and has broadly followed the movement in the Federal Funds Target Rate on a historical basis (Figure 1).

Figure 1



From each of those five sectors, the index selects the 10 securities whose stock prices have exhibited the highest near-term market-neutral correlation to movements in the U.S. 10-year treasury yield relative to their sector peers. This process is carried out a quarterly basis to ensure the index components reflect timely economic and market dynamics driving the relationship between equity markets and interest rates. The result is a diversified portfolio of 50 securities across 5 sectors that are well-positioned to experience stock price appreciation during times of rising interest rates. Figure 2 highlights the most periods of rising rates and the corresponding outperformance of NQERR against its benchmark, the Nasdaq US 500 Large Cap Index, during those periods.

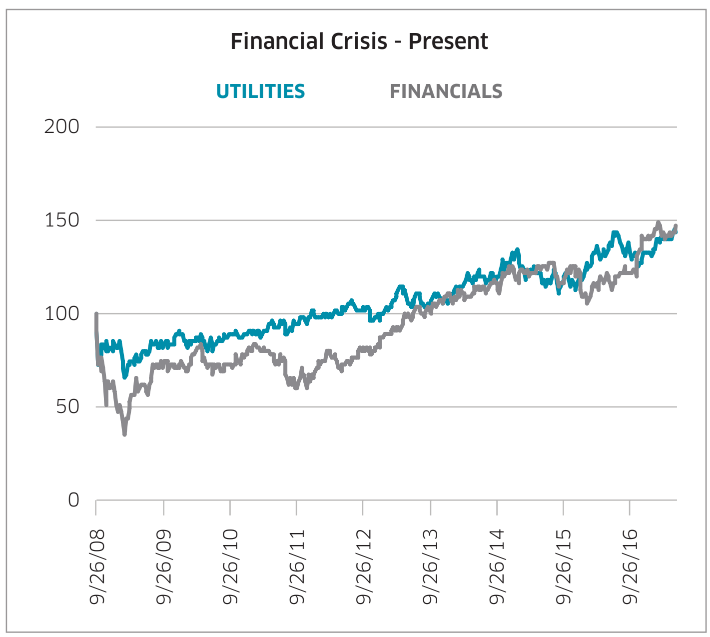
Figure 2

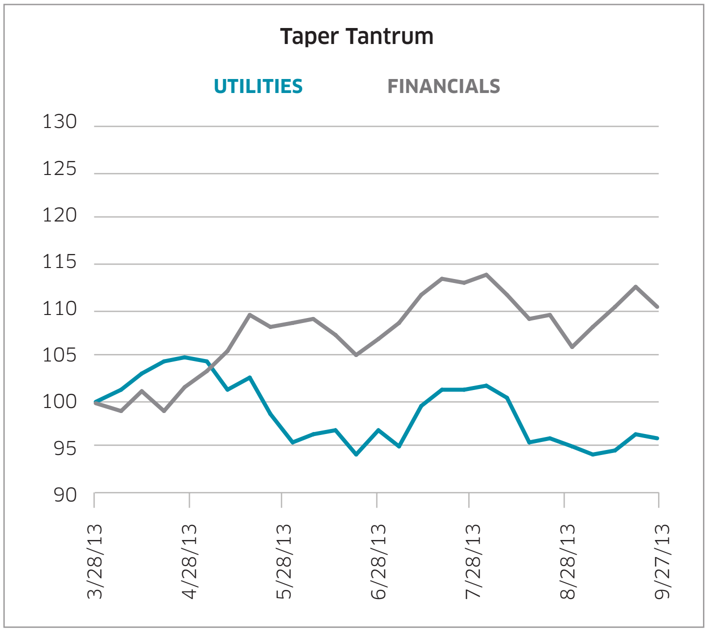


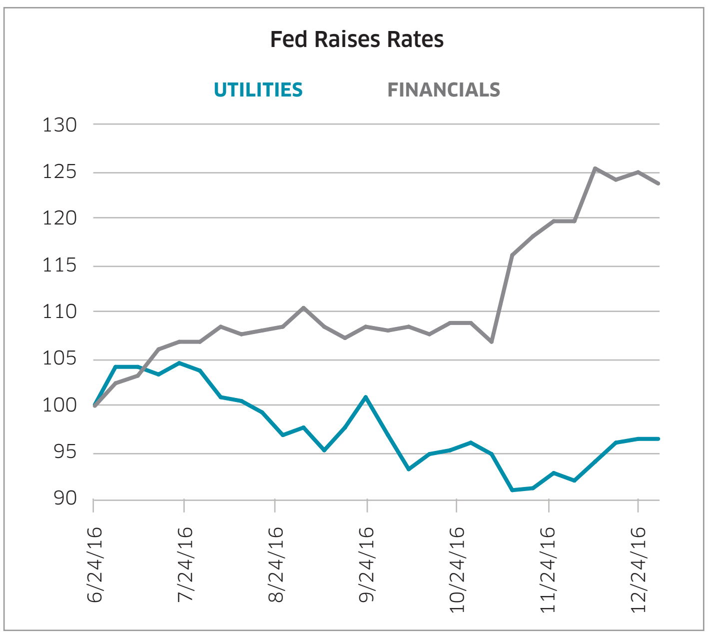
The Sector Story: Financials vs. Utilities

By targeting a sector-specific subset of the U.S. Large Cap universe, the Nasdaq US Large Cap Equity Rising Rates Index (NQERR) not only provides exposure to sectors that may potentially benefit from rising rates, but also purposefully eschews sectors that may be adversely impacted by the upward movement in rates. A comparison of the post-crisis performance of financials and utilities exemplifies the contrasting fortunes of various sectors during times of rising rates. On a cumulative basis, the two sectors have largely similar returns, albeit with dramatically different levels of volatility. Given their sharp underperformance during the nadir of the financial crisis, the fact that financials have recovered relative to utilities is largely due to periods of concentrated outperformance. Many of these periods coincided with a rise in the U.S. 10-year Treasury Yield, most notably during the 2013 "Taper Tantrum" and during the second half of 2016 as the Fed Funds Rate moved off near-zero levels. In each of these periods, financials were the highest ranked sector in NQERR, comprising 30% of the index weight. During these same periods, utilities were not present in the index.

Figure 3







This outperformance is largely due to the ways in which the two sectors operate and the manner in which investors view their respective short to medium-term futures. Investors generally perceive rising interest rates as having a positive impact on financials by increasing Net Margin Interest through new loans created during periods of higher interest rates.[1] Higher interest rates also signal greater economic activity, investment, and borrowing, all of which benefit the financial sector on the whole. In short, rising rates typically coincide with an expansive period in the business cycle, and the stock prices of financials have typically moved in conjunction with the overarching economic outlook.

In contrast, utilities are generally a lower growth sector that is less impacted by the rise and fall of the business cycle. During periods of low growth and low interest rates, utilities are typically favored for their low volatility and high dividend yield characteristics. During periods of higher growth and higher interest rates, those same characteristics are often seen as inhibitors to capturing the higher levels of growth and returns induced by increased economic activity.

The Nasdaq US Large Cap Equity Rising Rates Index (NQERR) offers a transparent, rules-based approach to capture these shifts in economic outlook and investor sentiment during periods of rising rates through a timely, diversified portfolio of Large Cap U.S. securities that have exhibited a tendency for outperformance under such economic and financial conditions.

The ProShares Equities for Rising Rates ETF (EQRR) tracks the Nasdaq US Large Cap Equity Rising Rates Total Return Index (NQERRT).

1 https://www.stlouisfed.org/on-the-economy/2016/may/banks-more-profitable-interest-rates-high-low

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