PSG Wealth

THE EFFECT OF RISING INTEREST RATES ON EQUITY INVESTMENTS

Current interest rate environments

In last month's note I commented on the absolute level of South African interest rates and suggested that although rates are increasing, the absolute levels of rates remain low and conducive to economic growth.

It's also worth mentioning that given the slow pace at which rates are projected to increase – only 25 basis points every other month- there is two material implications worth noting: Firstly, it could take multiple years before rates reach levels that materially restrict economic growth, and secondly, because the intervals are smaller, on their own they are likely to be less disruptive to the mark-to-market values of the various traditional asset classes.

That said, August turned out to be the most brutal month for financial markets in the year to date. It is therefore fitting that we review current market developments, explain PSG's positioning, and consider what can be done to lessen the stress experienced by our valued clients.

Current investment climate

As expected for some time, markets have continued to experience high levels of volatility. The JSE All share index experienced an average daily standard deviation of 1.6% during August. Similarly, during August the S&P 500 dropped 5.7% in one calendar week for the first time in nearly 4 years. So what has been driving the volatility in markets?

The source of volatility likely emanates from two primary sources. The fear of potentially rising US interest rates, and a weakening outlook for emerging markets.

US rates was broadly expected to increase this September. Investors were nervously looking on to see how the restricted spending power of the world's most wealthy consumer base would impact the earnings of firms dependent on the disposable wealth of the US consumer. This uncertainty has led to some profit taking on markets world-wide. Although there is a possibility that the Fed now has to delay its plans to hike rates, there is no denying that rates will have to normalize at some point.

In addition, signs of slowing growth in China and a deliberate devaluation of Yuan have damaged the outlook for commodity prices which negatively impacted the sentiment towards emerging markets. The sell-off in China and subsequent impact on other emerging markets was generally expected.

South Africa was off course included amongst the suffering emerging markets. The Rand seems particularly weak at the moment which is reflective of the poor economic outlook for the country.

PSG's positioning

Our fixed interest income orientated mandates remain focused on the protection and stability of income. Where there is equity exposure, it's limited and only exposed to entities that have a defensive and more reliable income streams. Commodities therefore do not fit the profile for these mandates.

Our wealth preservation mandate - the PSG Wealth Preserver FoF - remains defensively positioned with 30.4% in equities with a bias toward more defensive counters. The assets remain well-diversified across multiple regions, asset classes, sectors, and securities.

The Solution has a proven defensive nature: During the 2008/2009 bear market the maximum drawdown of the FTSE/JSE All Share Total Return Index was -45.4%. The Solution had a maximum drawdown of only -7.5% over the same period, and managed to recover this loss only 3 months after reaching maximum drawdown, as seen in the attached graph.

PSG WEALTH INVESTMENT INSIGHTS

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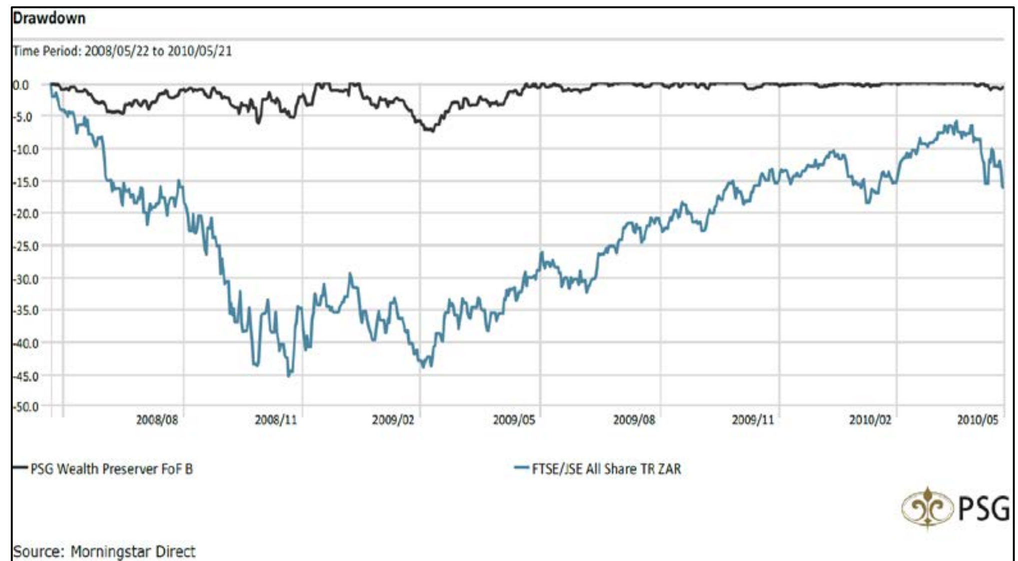

Graph 1

Our longer term mandates remain focused on growth. The nature of these mandate are less sensitive to short term macro-economic events and more focused on creating value on a bottom-up basis through a complete macro-economic cycle. As such, we have seen some moderately increased exposure to resource counters that are currently under immense pressure primarily due to lower spot prices which have severely impacted profit margins.

On a "through-the-cycle" view spot prices should normalize which will lead to an earnings recovery. When this recovery will take place is still an unknown, yet it seems reasonable that some moderate increases to these depressed areas of the market are justified.

It is not all about resources however, the growth mandates also remain heavily invested offshore. The valuations and earnings prospects for firms that generate revenues from abroad look far superior to those that are focused on the South African consumer.

What can be done to lessen the stress experienced by our valued clients?
Clients would be ill advised to make material changes to their portfolios at this stage, unless a review of the client's retirement plan or risk profile demands such a change.

Our portfolios remain well-diversified and strategically managed on a pro-active basis in accordance with our views of world markets.

Equity investors must acknowledge that the long term equity premium is a premium paid for tolerating short term uncertainty, and uncertainty is correlated to volatility. The higher the valuations, the more uncertain the short term outcomes are and the more volatile the markets are over the short term will be. This is the nature of equity investing.

Lastly, investors should take comfort in the fact that PSG has very robust financial planning and investment strategies that have been tried and tested in some very demanding conditions. Sometimes the best thing to do is to simply trust the experts.

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