THE EFFECT OF RISING INTEREST RATES ON EQUITY INVESTMENTS

PSG WEALTH INVESTMENT INSIGHTS

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Current interest rate environments

On 23 July 2015 the Monetary Policy Committee of the South African Reserve Bank decided to raise interest rates by 25 basis points to 6%. This is the third increase since the beginning of 2014. In total, interest rates are now 1% higher than the low of 5% in the current cycle.

The only other country in a phase of rising interest rates is Brazil which, like South Africa, is struggling with a weakening currency. Interest rates in the rest of the world are currently all constant or even declining.

The question on everyone's lips is when the USA will start hiking interest rates, as this will have a major impact on the rest of the world. It will be a clear sign that the American economy has recovered from the recent shattering recession to such an extent that interest rates can be normalised, without having a negative effect on the economic recovery.

Impact on investments

The big question for investors is to what extent a phase of rising interest rates will affect investment returns, and more specifically different asset classes.

Linked cash and money market funds earn an interest return that varies according to the interest rate levels. Rising interest rates therefore have a positive effect on returns.

Nominal bonds have a fixed-interest component (coupon) with a generally inverse correlation between the capital value and the prevailing interest rates. If interest rates rise, the capital value tends to decrease, and vice versa.

An equity investment, however, does not always have such a direct link with interest rates. Such an investment is made to share in the profits of companies (capital gains in price increases and/or a dividend as payment of part of the profits). The link between an equity investment and interest rates therefore lies in the indirect effect of interest rates on a company's earnings. High interest rates should be negative for equity prices, whereas low interest rates should have a positive effect.

A closer look at equity returns

The interest rate cycle can be subdivided into four phases based on absolute interest rate levels and the direction of movement, namely:

- Phase 1: Rising low interest rates
- Phase 2: Rising high interest rates
- Phase 3: Falling high interest rates
- Phase 4: Falling low interest rates

An analysis of the effect of interest rates on monthly equity returns over the past six interest rate cycles since 1978 (Graph 1) shows how equities performed in each of the above-mentioned phases (Graph 2).

It is clear that the return on equities in phases of falling interest rates tends to be much better than in phases of rising interest rates. However, it is also clear that the absolute interest rate level is also important. The return on equities in times of low interest rate levels is better than in times of high interest rate levels, for both rising and falling interest rates.

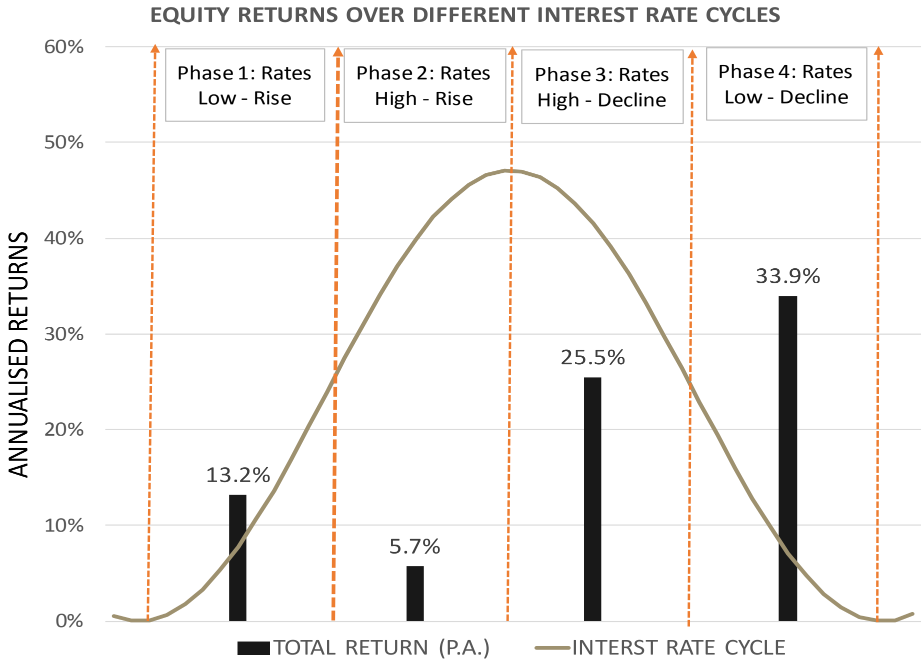
A further analysis of the return on equities in the various cycles shows that significant corrections in equity prices still occurred during times of the lowest interest rate levels (Phase 1) in 1980 and 1987.

What to expect going forward

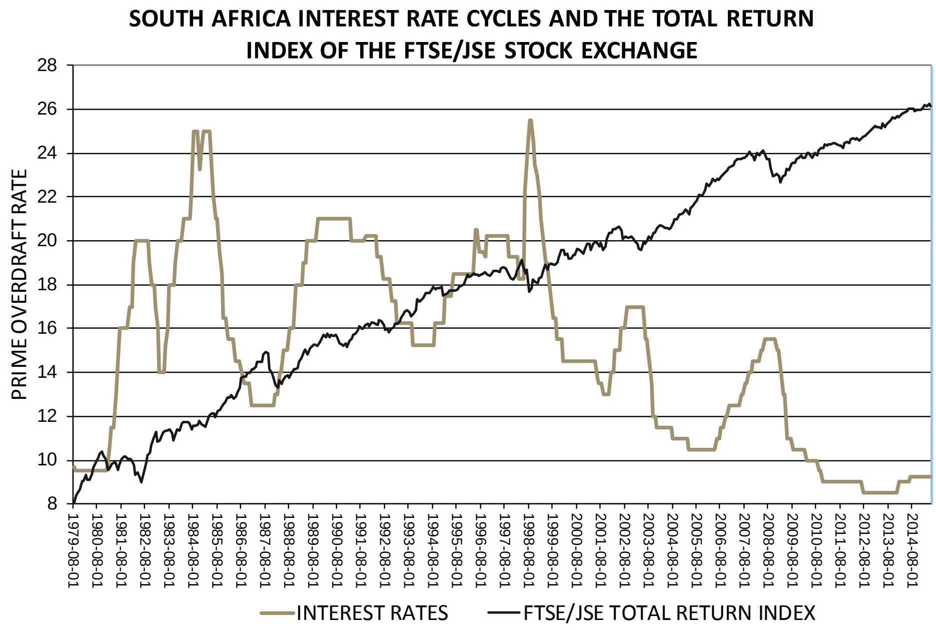
We have already entered Phase 1 of rising interest rates, but the absolute interest rate level is still low. What does this mean for investors?

The current interest phase is definitely not the worst phase for equities and investors should not start selling equities indiscriminately. The volatility of returns can be expected to increase. The extent to which investors reduce exposure to equities should rather be in accordance with their risk profile and investment objectives.

The current phase of rising interest rates is still a good time to accumulate investments in multi-asset funds, where a fund manager with an excellent track record manages asset allocation decisions.



Graph 1 - Analysis of the effect of interest rates on monthly equity returns over the past six interest rate cycles since 1978



Graph 2 - How equities performed in each of the above-mentioned phases