Equities: Threats and opportunities of rising interest rates

Peter Szopo

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US interest rates are on the rise. It took the Federal Reserve Bank ("Fed") twelve months, after the initial lift-off in December 2015, to make the second move, but for two reasons the odds of more frequent rate hikes over the next twelve months have increased. First, the Fed has turned more hawkish and second, inflation expectations have started ticking higher. Only recently, Chairwoman Yellen warned that "waiting too long to begin moving toward the neutral rate could risk a nasty surprise down the road–either too much inflation, financial instability, or both."

Investors' concerns

Rising rates are often seen as something equity investors should be concerned about. Concerns are related to

- shrinking valuations due to higher discount rates;
- pressure on earnings reflecting rising interest expenses of leveraged companies; and
- the shrinking gap between dividends and returns from interest bearing assets.

More generally – rising interest rates are also perceived as a bellwether of turbulences in financial markets.
The empirical evidence for those fears, however, is mixed. The last four times, when the Fed started a new rate cycle, there was some pressure on US equities for 2-4 months, but subsequently markets started to recover (except in 1994, when it took a year before the S&P 500 reached its level before the rate lift-off).

Sector winners and losers

As important as the direction of the overall market for equity investors is the impact of the new interest rate environment on investment styles and on the performance of sectors. Based on evidence from the US stock market, using monthly data since 2010, a couple of points are worth mentioning:

- The key winners in an environment of rising interest rates have been financials, particularly life insurers, banks and diversified financials. There is a strong positive, statistically significant relationship between changes in 10-year treasury yields and the relative performance of these sectors to the broader market.

  Source: Bloomberg; Erste Asset Management. Relative performance against S&P 500 versus changes in 10y treasury yields, Jan 2010 – Jan 2017.
- On the losing end are utilities, consumer staples, real estate and telecoms. The negative linkage is strong and statistically significant. It reflects the fact that these sectors mostly consist of high-dividend stocks, which are losing some of their appeal as interest-bearing assets are becoming more attractive. In addition, most companies in these sectors are also asset-heavy, financed by long-duration liabilities, and therefore interest-rate sensitive.

  Source: Bloomberg; Erste Asset Management. Relative performance against S&P 500 versus changes in 10y treasury yields, Jan 2010 – Jan 2017.
- There are a number of sectors, which seem to outperform in an environment of rising rates (e.g. capital goods, materials, energy) or underperform (health sector). However, the links are statistically not significant and too weak to be of any use for portfolio decisions, even if investors were confident enough to predict the direction of interest rates.

The consequences of changing interest rates for equity investors extend beyond pure sector effects. For example, data suggest that during periods of rising interest rates

- value stocks (typically stocks that trade at low valuations) tend to outperform growth stocks (expensive stocks expected to grow above average);

- cyclical stocks tend to outperform defensive stocks (which partly just reflects the sector effects described above);
- emerging markets tend to underperform stocks in developed markets, and
- gold prices are affected negatively because rising interest rates increase the opportunity costs of holding gold. Consequently, physical gold and gold stocks tend to underperform the broader equity markets during periods of rising interest rates.

Source: Bloomberg; Erste Asset Management. Relative performance against S&P 500 versus changes in 10y treasury yields, Jan 2010 – Jan 2017.

Health warnings

The charts above need to be seen with a grain of salt. They show some empirical regularities but before using them as an input in investment decisions more, deeper statistical analysis would be required.

One of the main caveats is that the statistical properties of the empirical relationship between interest rates and stock performance are weak, i.e. typically changes in interest rates explain only a small part of the variability of stock returns.

In addition, the relationship between interest rates and stock returns – like most empirical patterns in financial markets – is not stable. During periods of financial stress and/or aggressive monetary tightening, supposedly well-established linkages often break down and winners of rising rates, particularly financial stocks, could turn into losers.

Moreover, the links between interest rates and stock returns shown above may just reflect the simultaneous response of both variables to other economic developments such as growth and inflation expectations. As Ed Leamer, a renowned econometrician, once stated: “Correlation is in the data but causation is in the mind of the observer”.

Finally, the slope of the yield curve matters. If, for example, rising rates are accompanied by a flattening of the curve, both positive and negative effects of interest rate movements are usually mitigated.

Bottom line: Odds have increased that US interest rates will increase. While the new normal will likely be lower than historical levels, and the spill-over to Europe will be delayed, investors need to adapt to a new environment. Rising interest rates go hand in hand with a rotation of sectors and investment styles. It seems likely that financials and other cyclical sectors will continue to enjoy some tailwind, while non-cyclical consumers, utilities and real estate will be facing headwinds. This said, none of these developments will follow a mechanical, predictable pattern offering easy profits.

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Peter Szopo

Peter Szopo has worked as chief equity strategist at the Erste Asset Management since March 2015. Before he already worked as a consultant for equity fund management at Erste Asset Management for Central and Eastern European equity markets. From November 2009 to April 2013, he was head of the research department at Alfa Bank in Moscow.

After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

Along with his analysis activities, he worked from 1997 to 2000 at Eastfund Management as the fund manager for Central and Eastern European equity.