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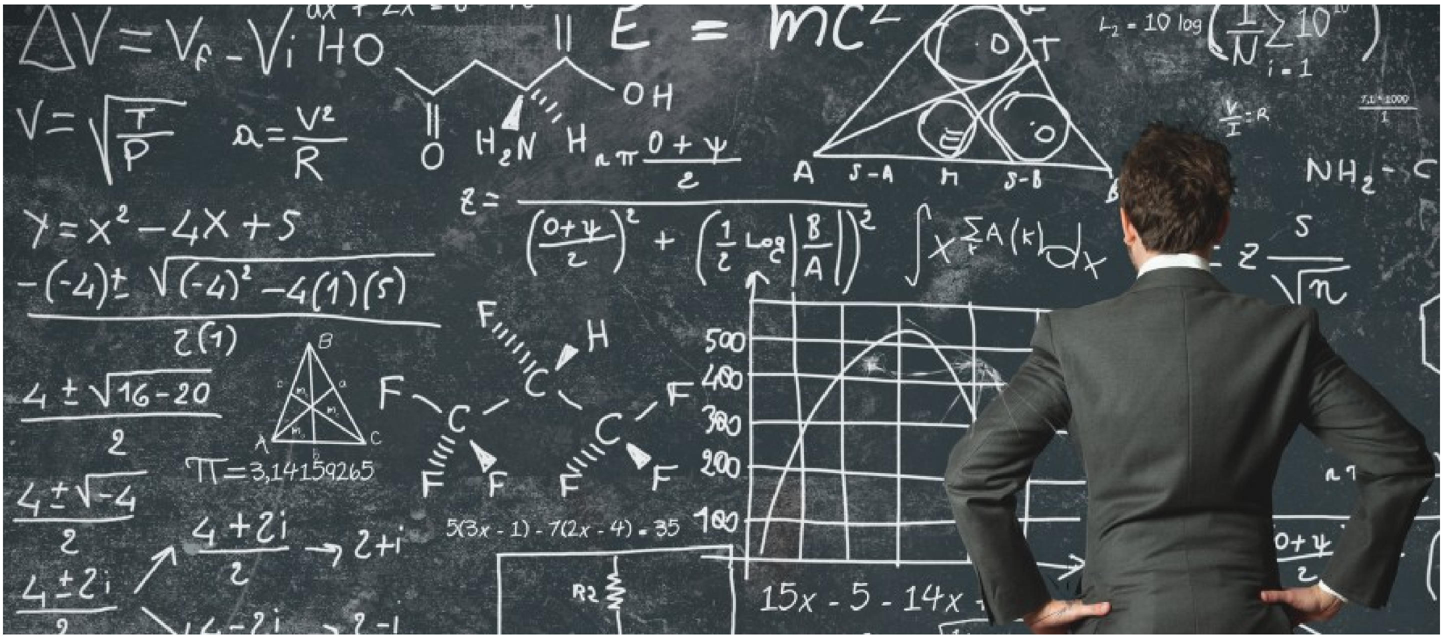
Equities amid rising interest rates

Harald Egger



Equities have without a doubt benefited from falling or low interest rates in the past. Along with company earnings, the level of interest rates is indeed a crucial driver of dividend-paying shares.

Clearly, when earnings are up, so is the share price. The effect of interest rates is the opposite one: the higher the interest rates, the lower the valuation of shares. This is the case because investors prefer a safe return to risky investments. In the recent past, there have been practically no safe returns, as a result of which investors have been “forced” to take risks and to also invest in equities so as to generate return.

Has the upward trend reached its peak?

Interest rates are driven by inflation, among other factors. Deflation, which was an issue in 2015, is currently no concern. The central banks have therefore begun to “normalise” their very loose monetary policies. This return to a normal state of affairs has had some equity investors wonder whether the upward trend might soon peak out.

Inflation (in the USA) back to 2% – currently no risk of deflation

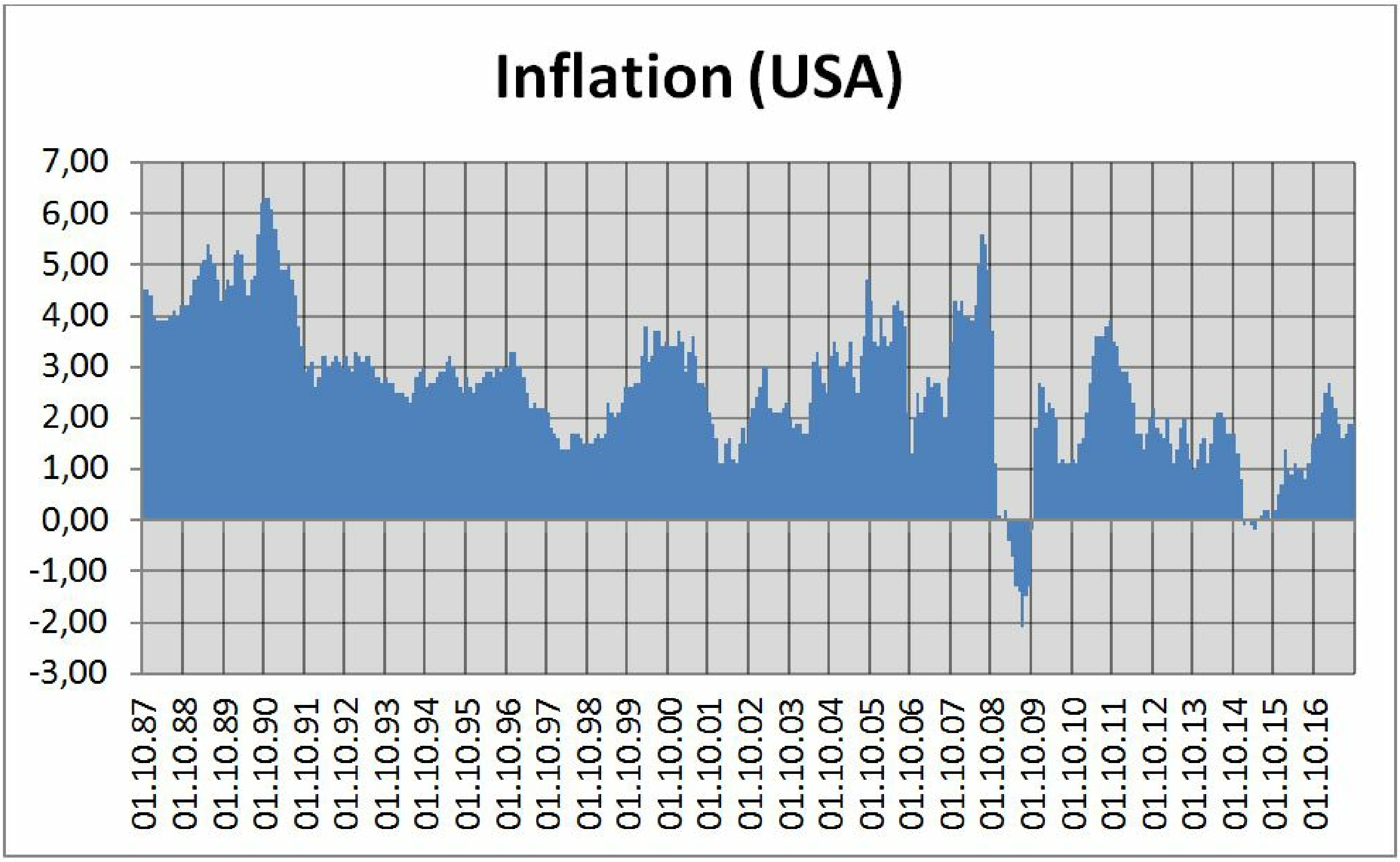


Fig. 1, source: Datastream, 1987-2017

The chart above, figure 1, shows that inflation has increased in the past two years from below zero to a “normal” level of about two percent. In spite of rising inflation, the equity markets have continued to grow in the past two years. Valuations have generally increased as well.

Does that mean that rising inflation has no impact on the valuation of equities anymore? The following chart should answer this question.

Link of rising inflation and falling valuation

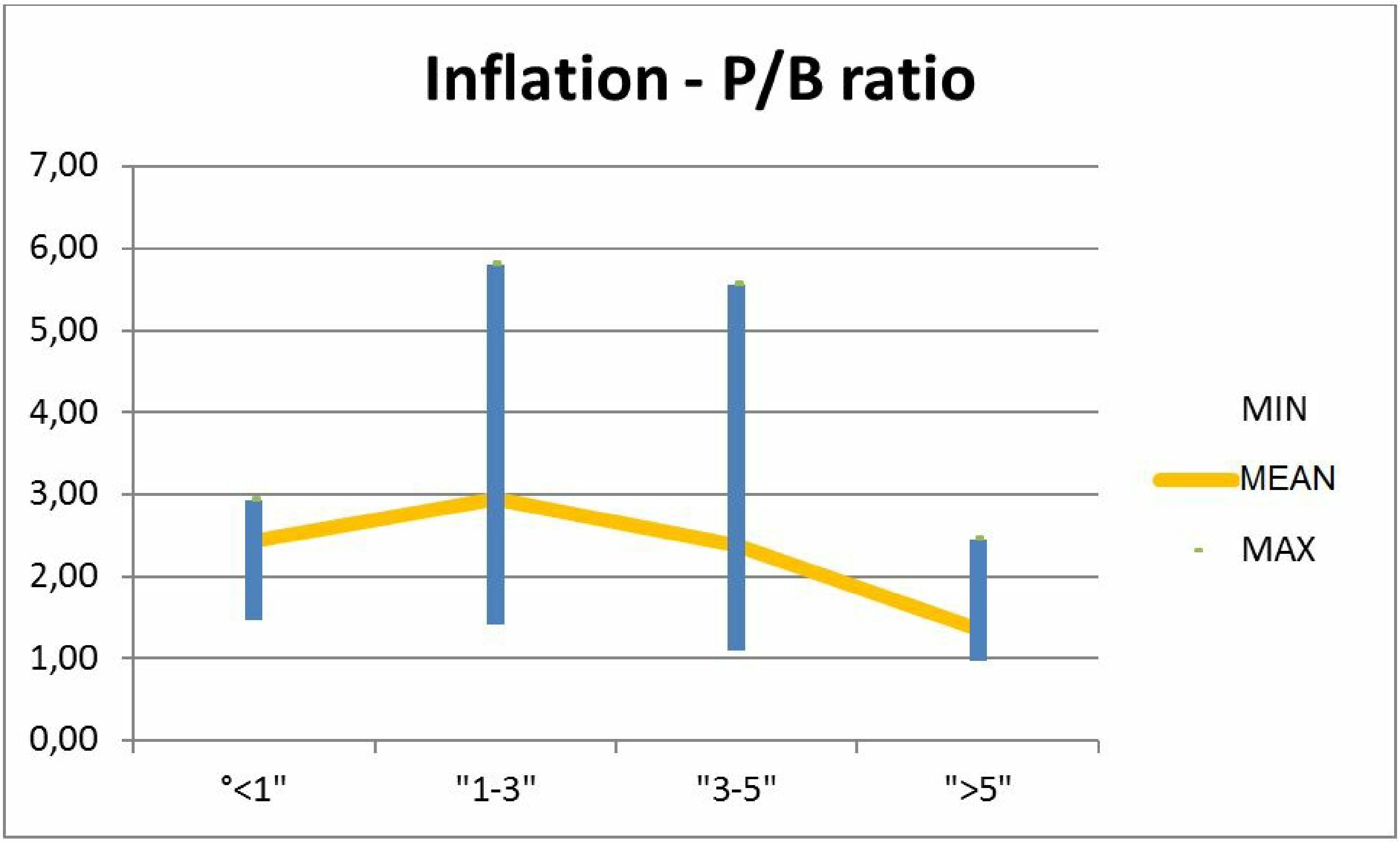


Fig. 2, source: MSCI, Datastream, P/B (= Price-to-Book-Ratio)

Figure 2 illustrates the relationship between inflation and valuation (price-to-book-ratio for the entire US market). The blue bar represents the bandwidth of valuations of US companies in the past 40 years. Here, higher inflation does indeed lead to lower valuations on the equity markets (as illustrated by the respective averages). However, this relationship only holds for inflation rates of above 3%. In the past, we have seen the highest valuations at an inflation of around 2%. However, if inflation falls significantly below 2%, the aforementioned relationship breaks down: falling inflation of below 2% does not result in higher valuations, but instead valuations start falling again. We have recorded this phenomenon in Japan: many companies find it difficult to boost their profits in a strongly deflationary environment.

The “magical” 3% mark of inflation

Equity markets have benefited instead of the opposite in the past two years, because the risk of deflation has not managed to come to the fore. Rising inflation in a bandwidth of zero to two percent tends to go hand in hand with higher valuations. We are currently at a sweet spot, i.e. valuations are highest when inflation hovers around 2%. Risks tend to start materialising only at levels of above 3% – we currently do not see this sort of threat.

Correction looming in case of substantial yield increase

If, against our expectation, inflation were to continue rising and pull government bond yields up along with it, equity markets would probably react by pruning their valuations. A correction or stagnation would then be very likely. Rising earnings could only partially compensate for this effect.

Value shares for scenarios of rising bonds yields

Investors who expect this scenario of significantly rising yields but who still want to invest in equities should focus on value shares as opposed to quality shares. Value shares are not necessarily tantamount to “undervalued” shares per se. They just have a lower price/earnings (PE) or price/book value ratio.

What, then, are value shares?

At the moment, mainly financials and commodity companies. Bank shares benefit from a steep yield curve, i.e. from clearly higher yields for longer maturities than shorter ones. The profits generated by commodity companies should benefit at disproportionately high rates from rising inflation. Interested investors should maintain their focus on value shares until the first signs of recession emerge. At that point, quality shares, i.e. shares from financially strong companies, should start outperforming value shares again.

Figure 3 shows the relationship between the outperformance of value shares and the development of the yields of 10Y US Treasury bonds. The link between the two is clear. When yields are rising, value shares (mainly financials and commodity companies) outperform the rest. If yields really were to continue rising, the underperformance of value shares, which has been in place since the financial crisis, could come to an end.

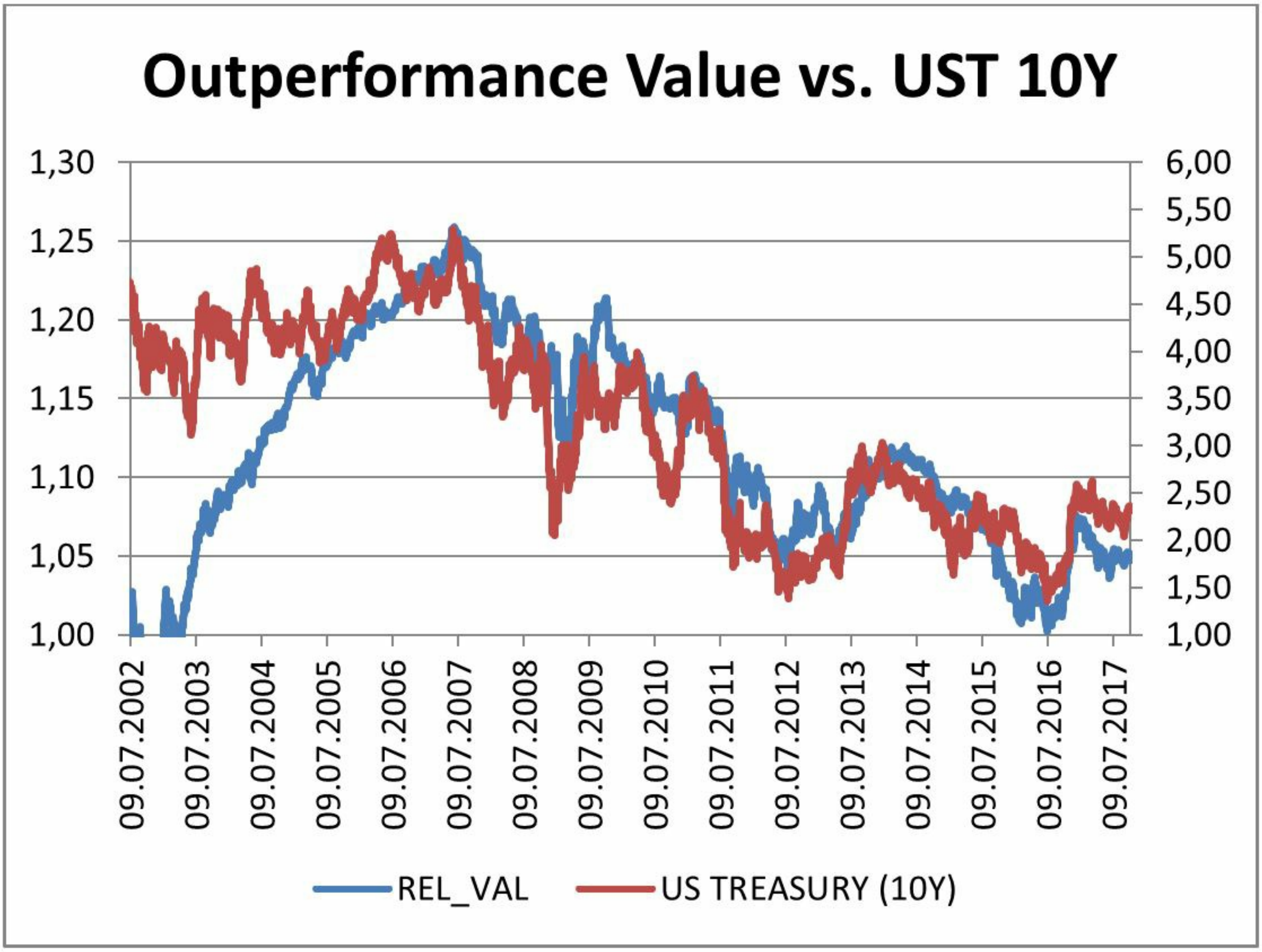


Fig. 3, source: Bloomberg, MSCI
Note: The performance does not account for fees or taxes. Past performance is not indicative of future development.

Legal note:

Prognoses are no reliable indicator for future performance.

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Harald Egger is Chief Analyst and has worked at Erste Asset Management since 2001. Previously he worked for four years as a fund manager and analyst for AXA Investment Management in London. He headed the equity segment within Erste Asset Management and was CIO until April 2013. He has been employed in the finance industry since 1992.