Understanding the impact of interest rates

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Interest rates

Interest rates are the cost of borrowing money from a lender, and businesses and individuals borrow money for a range of reasons, so lending plays a significant role in the global economy. There is some ambiguity around interest rates, so hopefully, the following can bring some clarity.

Treasury Yields

Treasury yields are the stated interest rates that the United States government will pay to borrow money where the borrowing is backed by the full faith and credit of the U.S. government. Treasuries are as close to risk-free as an investment can get, so they serve as a baseline and any yield greater than treasury yields has an added risk premium. They are the most influential interest rate as they affect both businesses and individuals when borrowing money for purchases of long-term assets like real estate and borrowing for businesses. Treasury rates are also used as baseline inputs for valuations of assets like stocks and bonds, meaning changes in treasury yields also change the relative values of other assets. Treasuries influence the sentiment of the U.S. economy: rising rates suggest a positive economic outlook, and as we are experiencing now, it can also reflect a changing inflationary environment.

In order of shortest duration, the U.S. government issues Treasury bills (within one year), Treasury notes (2-10 years), and Treasury bonds (20-30 years).

A vital graph used to predict changes in economic output and potential interest rate changes is the yield curve. The line on the graph shows the spread between the 10-year and 2-year treasury yields. When the graph below is above 0, the 10-year rate is higher than the 2-year rate. A flat or humped yield curve has treasuries earning similar rates and can indicate economic uncertainty. Likely the most frightening yield curve for multiple reasons is an inverted yield curve, when 2-year yields are higher than 10-year yields. This happens when investors are less confident about the future and don't want to lock up their money for a long amount of time. The fear stems from the historical correlation between inverted yield curves and recessions as seen below.

Federal Funds Rate

The federal funds rate is a target interest rate (a range of rates) set by the Federal Open Market Committee (FOMC) that serves as the rate at which commercial banks borrow and lend excess reserves to one another overnight. The FOMC sets the range in response to economic conditions to achieve economic growth. As consumers experience the change in interest rates, their spending behavior will typically reflect the change which will impact business and force companies to adapt, all of which affect the economy.

Interest rates cont'd

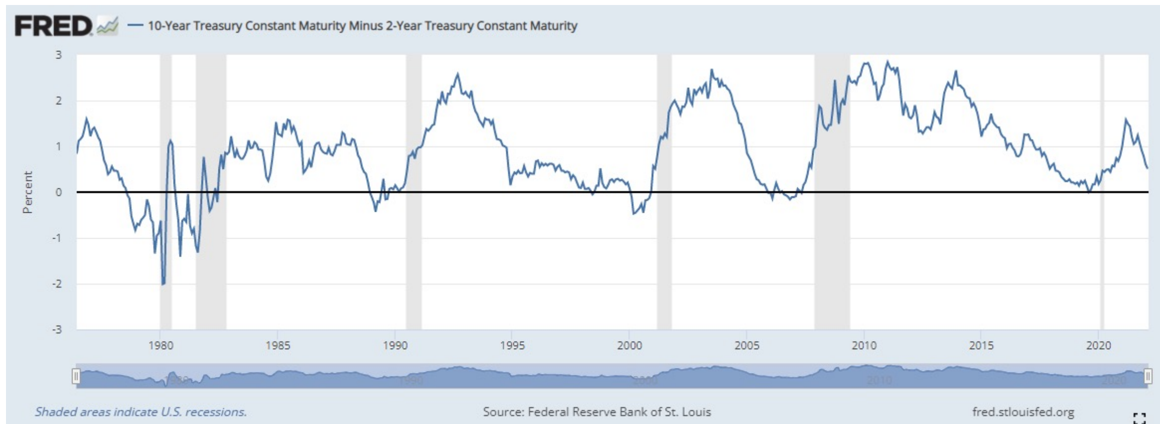

Figure 1: The inverted yield curve throughout time. Shaded in gray are periods of recessions.

The fed funds rate influences short-term rates and impacts economic factors like growth and inflation. A consumer can notice these changes with higher or lower interest rates on their credit cards and similarly with mortgage payments- both of which are core categories to the consumer. Comparably, businesses can get access to cheaper or more expensive debt, which can accelerate or decelerate growth in the company. A favorable change in the fed funds rate grants businesses accesses to cheap capital, enabling them to fund growth opportunities. This leads to job creation, so individuals earn money to support spending, which essentially stimulates the economy.

Prime Rate

Also influenced by the federal funds rate is the prime lending rate- the rate that banks charge their most creditworthy borrowers. This rate serves as the starting point for interest rates charged to consumers. This typically affects consumer-oriented loans like personal loans, car loans, mortgages, etc.

Discount Rate

The discount rate is the rate the Fed charges commercial banks for short-term loans borrowed from the Federal Reserve. The rate is set by the board of the Fed. This borrowing is rare and typically for emergencies as it is used when a bank cannot find a lender in the open market.

Recent interest rate activity

Throughout the past two years, due to quantitative easing and money creation, money supply has exceeded the supply of goods and services. Consumer balance sheets were strong, but due to lockdowns, travel restrictions, and supply chain constraints, there was a shortage of goods and services, resulting in lower spending and higher levels of cash balances. Throughout time, states, borders, businesses started reopening, which helped boost the economy.

With respect to financial markets, at the beginning of the pandemic, the Federal Reserve implemented quantitative easing by purchasing assets like treasuries and mortgage-backed securities as a form of quantitative easing to increase the supply of money to encourage borrowing and investing. It's important to note that, at the time, interest rates were near zero, and naturally, there is an inverse relationship between the supply of money and interest rates. Quantitative easing has been credited to keeping markets afloat during the pandemic.

To summarize, inflation is the product of consumers having had too many dollars (savings and stimulus payments) chasing too few goods (restrictions and constraints) coupled with 7 billion notes being printed in the United States in one year, accounting for a substantial amount of all US dollars in circulation.

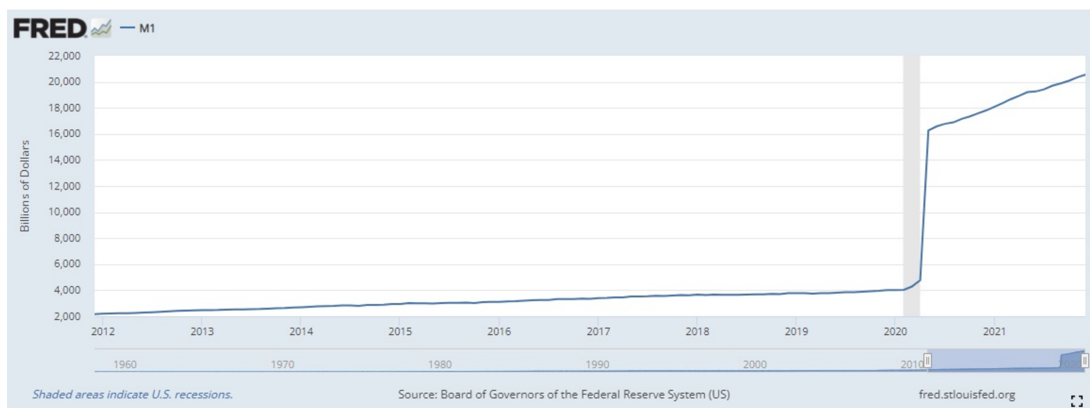

Figure 2: Money supply overtime. A clear, dramatic spike in the past 2 years.

Fast-forwarding to around the end of 2021, the U.S. started experiencing higher levels of inflation, reporting the highest levels in the CPI measurement since the 1980s. To combat inflation, the Federal Reserve will adjust the federal funds rate to affect the supply of money.

Recent interest rate activity cont'd

In the case of high inflation, generally, the Federal Reserve will increase interest rates to slow down borrowing, which impacts businesses and individuals, which in turn can slow down the economy. Higher rates can slow down the economy with investing and spending slowing as expensive borrowing can be discouraging.

Figure 3: The CPI over time; a measurement of inflation. The CPI is a price index where the price is a weighted average market basket of consumer goods and services.

How do stocks perform in high interest rate environment?

Pre-pandemic and after the V-shape recovery, stock valuations were at historically high levels. A low-interest-rate environment can be attributed to high valuations but now, as we enter an environment with expected rate hikes, some stocks can experience downward pressure because of the nature of the interplay between interest rates and valuations. Growth stocks are sensitive to a rise in interest rates because companies must deliver higher growth to compensate the investor for allocating cash to the company rather than earning a rising risk-free rate. It's also important to note that when building a discounted cash flow model, a higher discount rate will lower generally lower the valuation of a given stock.

The context behind rising rates is likely more important than the direction of rates. For instance, if rates rise because of economic growth, this is good for businesses and can be a driving force to raise the price of stocks. What is important is the volatility of interest rates as investors are not comfortable with uncertainty. The importance of volatility is highlighted in the consequences of rate changes; if the Fed moves rates too much or too fast, it can cause a recession. Conversely, if the Fed takes too long, runaway inflation can occur.

How to invest in a rising rate environment

The following companies are listed as examples to provide context. These are not recommendations.

REITs

Well-managed real estate investment trusts tend to perform well during high inflation periods given their perks of having attractive dividend yields, diversification, and ability to hedge inflation through the underlying asset. Rates are increasing because of inflation, and real estate has continuously been an inflationary hedge. So, the primary reason that rates are increasing is not enough to deter performance in REITS. Interest rates can impact REITS in that it may increase monthly payments and it can also be more costly to purchase additional property. Notably, the sentiment around real estate amongst institutional investors is positive, which can hint at a positive tailwind for the sector.

Mortgage REITs are comprised of mortgage investments (mortgages, mortgage-backed securities, etc.) and generate revenue by borrowing money cheaply and investing proceeds in long term securities with higher yields, so revenue is generated from interest on investments. Naturally, mortgage REITs benefit in an environment where long-term rates are higher than short-term.

Equity REITs own and operate commercial properties, so revenue is captured through rental income. The recent rise in rent can be a catalyst to REIT investors.

Hannon Armstrong Sustnbl Infrstr Cap Inc (HASI): This REIT specializes in clean energy and infrastructure by investing in wind, solar, and other sustainable energy operations. The infrastructure bill can be a potential catalyst for the investments in this REIT. The dividend yield of this REIT is 3.22%.

Healthcare

Historically, the healthcare sector has performed well in a rising interest rate environment as it is a defensive place for investors to hide and has inelastic consumer qualities. The rise in interest rates is likely of no immediate concern to an individual needing health care.

Pfizer (PFE): A blend of positive historical performance and a portfolio of popular inelastic goods creates a good fight against inflation.

How to invest in a rising interest rate environment cont'd

Consumer Staple

Big box retailers, toothpaste manufacturers, and other consumer goods deemed inelastic can oftentimes pass on the costs to consumers, which will not harm these companies. Typically, these stocks are classified as value stocks, and they tend to do well in a rising rate environment.

Costco (COST): Costco is a defensible business given its strong consumer loyalty, membership business, and nature of their business. Consumers will continue to shop at Costco during periods of high inflation, and Costco can pass along the costs to consumers

Commodities ETFS

Historically, commodities have been a very strong asset class for investors to benefit from inflation. Commodities have different functions but serving as an inflationary hedge has long been the thesis to hold commodities.

Invesco DB Commodity Index Tracking Fund (DBC): A diversified ETF of durable commodities like oil (will do well in this environment), gold (strong inflation hedge), silver, aluminum, corn, wheat, sugar, and more

Financials

An increase in rates means higher interest payments, which is a benefit to businesses in the financial sector. Also, if there is economic growth, companies may borrow more to finance growth. Financial firms borrow at the cheaper end of the interest rate range and typically lend at the longer end of the range (i.e., 30-year mortgages). This means financial firms not only benefit from a rise in rates, but they also benefit from a steepening of the yield curve.

JPMorgan Chase (JPM): Remarkable, veteran leadership with a defensive and growing business poised to benefit from rising rates is found in JPMorgan Chase.

In summary, stocks can still do well in a rising rate environment if the underlying asset, the business, can benefit or at least not be adversely affected by rising rates. As an example, financial companies often benefit from rising rates due to the nature of the business strategy. Such periods highlight why individual security selection can be a successful strategy if the portfolio is adequately accommodated.

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