What do Rising Rates mean?

It has certainly been an interesting start to 2022 with major equity markets declining sharply as expectations of central bank tightening become more entrenched. After several years of investment returns being boosted by declining interest rates the environment looks to have changed, at least for the next couple of years anyway. Investors need to consider what this means for their investment strategy and if any changes are required.

We wrote last year about the Great Rotation from Growth to Value which has continued to play out. Essentially a higher interest rate environment is a potential headwind for stocks but usually more for higher priced higher growth stocks that will earn most of their profits in future years. Value stocks are generally lower priced, lower growth stocks in established sectors like financials or industrials. They have the advantage that they make good profits right now and generally benefit from stronger economic conditions, usually the premise for why interest rates are rising, at least in the first couple of years of the interest rate cycle. So where are we at now?

The Reserve Bank of NZ has already increased interest rates twice with the OCR currently 0.75% and very likely on its way to 2-3% over the next 12-18 months. Corporate bond and mortgage rates reflect these expectations. Other central banks, like the Bank of Korea have also started increasing interest rates, and the US Federal Reserve is now expected to increase their Federal Funds rate from zero to around 1% this year and probably towards 2% in 2023. The Reserve Bank of Australia will likely join the trend and head towards hiking rates shortly also. If you are investing for the medium to longer term this change in environment is not a large cause for concern, but it does have some implications for a balanced portfolio.

For Fixed Income buy and hold investors rising rates are positive as you can invest at more attractive rates than in recent years. A 5- or 6-year corporate bond yielding 3.5% is far more attractive than the yield trough last year closer to 2%, even if the real yield, after inflation is still not that attractive. For stocks, two things are true. First, rising rates over time reduce the relative attractiveness of stocks compared to fixed interest investments, and second, rising rates decrease the worth of future corporate earnings which is why companies that are cheaper relative to their current earnings are less affected than higher priced exciting growth companies that currently make little or no profit. With higher inflation being the cause of the end of central banks low interest rate policies it is important to think about which sectors of the market, and companies specifically are best placed to deal with the changed environment.

Pricing power is a key ingredient to weathering the pressures from higher inflation and higher interest rates. **Procter & Gamble**'s most recent quarterly results highlighted that they are increasing prices for many of their products to pass on higher input costs. The importance of this is that they *can* raise prices because of the brand strength of their products. If you have no pricing power, then you get squeezed. For banks the pricing power in a rising rate environment is essentially given to them with borrowers paying more but a lot of deposits in transactional accounts (billions of dollars) still earning zero or close to it. There are some stocks that are caught between the Growth and Value themes and **Microsoft** is one of those. It has suffered recently as higher priced Growth stocks are sold down but it also enjoys strong pricing power and is better placed than most to keep increasing its earnings despite higher interest rates. Market weakness is likely a good opportunity to buy into a great business like this.

Many of the pandemic winners are coming crashing back to reality. **Peloton** has fallen 80% from last years highs as the craze for internet connected fitness bikes wanes. Crypto currencies are sliding as the prospect of higher US interest rates restores some credibility to the value of the buck. Expect the frothiest areas of the asset markets to continue to struggle in 2022 as actual corporate earnings become more in focus than hopes and dreams for the future.

The companies mentioned above are named to further the discussion. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends discussed above.

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