FIMARGE
your independent wealth managers

August 2015

WHAT IF INTEREST RATES CONTINUE TO RISE?

GUILLEM BIENERT
Portfolio Management Director
Fimarge SFI, SA

In recent weeks we have perceived some nervousness in the market caused by the future evolution of interest rates. The market consensus suggests that this is a change of trend. Undoubtedly, this perception is more pronounced in the European yield curve rather than in the US one.

The President of the Federal Reserve (Fed) announced its intention to start raising the intervention rate by the end of the year if economic and employment conditions continue to improve. The latest figure for US GDP growth in the second quarter was 2.3% of annualized improvement. Let's recall that the Fed started a drastic reduction of the interest rate in July 2007, then set at 5%. Successive cuts brought the interest rate to 0.25% in March 2009, where it stands today. During this period the 10-year US treasury has dropped from 5% to a low of 1.5% in July 2012, just before the Fed announced its intention to gradually reduce the pace of its monetary expansion policy. Since then, rates in the different sections of the US yield curve have gone up with some volatility. Undoubtedly, the recent upward trend of the 10-year rate up to 2.4% has been the precursor of the general opinion that this is a cyclical change in interest rates.

The impact of this change can be decisive for the future development of financial investments. In my previous article I mentioned the inverse relationship exisiting between interest rates and the price of bonds. When rates rise, existing bonds lose value. For equities, a sharp rise in interest rates may also trigger a stock market correction. One reason for this is that with a higher interest rate future cash flows or dividends from a company are worth less when they are discounted. The value of the company falls because shareholders cannot obtain these future dividends with the existing higher rates.

It is true that the rise in interest rates the market is expecting is linked to an improvement of economic conditions and company results, therefore validating the current valuations of the stock market and allowing for, if possible, greater appreciations. However, there is a risk that a rate hike made too soon or too aggressively will halt that growth and cause a correction. Some stock market corrections have occurred not at the beginning of the interest rate cycle reversal, but later. The truth is that the Fed is facing a high execution risk.

How can we take advantage of the change in the interest rate cycle in our portfolios? In previous times of economic recovery and interest rate hikes the emerging markets in dollar denominated sovereign debt and shares have performed very well. In the current situation emerging sovereign debt offers a 10-year yield of 5.5% and equities (MSCI Emerging Markets) present attractive valuation ratios (P/E of 12x, P/BV of 1.6x and dividends of 2.6%). The portfolios of our investors are moderately beginning to take positions in this asset class.