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SPECIAL ISSUE

Policy Rates Opinion Compendium: Impact on Equities

May 2015

Henning Gebhardt

Your entry to in-depth knowledge in finance

Marketing Material

Message from Phil Poole

In the years following the financial crisis, the European Central Bank (ECB), the US Federal Reserve Board (the Fed), the Bank of England (BOE) and the Bank of Japan (BOJ) broadly kept step in a synchronized pattern of low policy rates and, to one degree or another, additional "extraordinary" monetary measures such as quantitative easing. But things are changing and in 2015 monetary policy from major central banks looks set to diverge.

There has been an economic upswing led by the United States, but the pace of economic growth has not been uniform across the globe, leading to speculation about how monetary policy will play out differentially in the coming months and years. This leads us to ask the question of not only when but where policy rates will begin to normalize and what the implications will be for the global economy, financial asset prices and major currencies.

To offer investors a truly well-rounded, insightful perspective on this topic, I have launched an opinion compendium project together with Deutsche AWM. The compendium will tap the expertise of our key investment experts, product specialists and leading academics from the University of Cambridge and University of California at Berkeley, including New York Times bestselling author Professor Barry Eichengreen.

Deutsche AWM will publish a series of concise articles on this topic over the coming months, studying the global monetary policy story as it unfolds. It will approach the topic from three primary angles: 1) "How low for how long?", 2) "What will be the impact on global growth?", and 3) "How will financial asset prices respond?"

In this installment of the series, Henning Gebhardt, Deutsche AWM's Global Head of Equities in Frankfurt, provides an insightful look into the impact on equities. Given the times we live in, what he provides is a reality check as opposed to a textbook view. He points out that the impact of changing monetary policies depend on industry sector as well as different "types" of rate hikes.

I am very pleased to be collaborating with these leading international experts, both external and from within our own organisation, on this very relevant and timely topic.

Kind regards,

Phil Poole
Managing Director, Global Head of Research
Deutsche Asset & Wealth Management

Phil joined Deutsche Asset & Wealth Management in January 2014 with 30 years of industry experience. Prior to his current role, Phile was a managing director at HSBC, where he served as Global Head of Macro and Investment Strategy for its Global Asset Management business, preceded by a period as Global Head of Research and Chief Economist for Emerging Markets on the sell-side. Prior to HSBC he worked in senior sell-side research roles for Barings / ING Barings, and Barclays.
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Mr. Gebhardt joined Deutsche Asset & Wealth Management in 1996. Prior to his current role, he served as Head of EMEA Equities, and before that as Head of European Equities and Head of German and European Small & MidCap Equities. Earlier, Mr. Gebhardt was on the International Equity Team, where he was responsible for Asian, Japanese, Emerging Markets, and Global Funds.

Mr. Gebhardt completed the Bank Training Program ("Bankkaufmann") at Commerzbank. He holds a Master's Degree in Business Administration ("Diplom-Kaufmann") from the University of Goettingen. Mr. Gebhardt is a CFA Charterholder.

Shelving the textbook: Equity price forecasts struggle in rising rate environments

Henning Gebhardt

May 2015

The prospect of a rise in interest rates is of great concern to equity managers as it entails both risks and opportunities for stock markets. Contrary to the stylized relationship that is often propagated in text books, the effect of a change in interest rates on equity prices generally proves more complex and ambiguous, whereby the task of anticipating related market moves becomes a challenge. The current discussion about the likely impact of a FED rate hike on stock markets provides an example for this ambiguity. Factors that contribute to the complexity of this relationship are the nature of the underlying interest rate change, its interaction with other equity price determinants, and the varied response by economic sectors.

Rising rates by the book

Rate hikes are commonly expected to take place during periods of above-average growth, rising inflation and tighter labor markets, given that central banks aim to keep inflation in check by influencing the pace of economic growth. In theory, such an increase in interest rates negatively affects stock prices because they should correct for the expected cooling of the economy: Higher interest rates bring about higher borrowing costs for individuals and companies, which lead to lower spending by consumers and businesses. The lower demand for goods and services in turn leads to lower corporate revenues and - coupled with margin pressure due to higher inflation, tight labor markets, and higher borrowing costs - lower profits. The stock market tends to anticipate this slowdown and reduces its earnings expectations accordingly, thereby causing stock prices to fall.

As already pointed out, the relationship outlined above is rather stylized in that it describes very broad interactions, which in reality can pan out in any number of ways. Interest rates have a wide and varied impact on and across economies, and all of the aforementioned factors are interrelated as are their outcomes. Thus it is difficult to state with confidence that a rising rate environment will have an overall negative effect on stock prices.

For example, gradually rising rates accompanied by low inflation and economic growth tend to point to a strengthening economy, and therefore often coincide with still rising profit margins and earnings growth. Therefore, stock prices may continue to rise, if interest rates do not rise too fast and too high, the economy continues to grow without signs that it is overheating, and companies deliver consistent earnings. In the end, interest rates are a central determinant of stock market trends, but only one of many considerations that go into the evaluation of stock prices.

Varied reactions by sector

The mixed effect of a change in interest rates on equity prices can also be observed when stocks are broken down into subcategories. Whereas certain company characteristics and industrial sectors perform poorly in a rising rate environment, others actually tend to perform better. Key valuation drivers in this case are the resulting change in the discount factor and the level of economic activity associated with the different stages of the rate cycle.

For example, interest sensitive stocks show a strong negative correlation with the movement in interest rates, which typically causes them to underperform the market during periods of rising rates. The negative correlation is linked to the impact on their cost of capital, which serves as discount factor in the company valuation. Included in this category are companies with high levels of long-term debt,

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whose cost of borrowing is contingent on the risk free rate and may in turn affect their profits and dividends (e.g. real estate companies) as well as companies with relatively fixed dividends but little or no growth (e.g. utilities). Similarly, stocks with high betas tend to be more sensitive to interest rate changes, given their higher exposure to moves in the risk free rate, as is also implied by the capital asset pricing model.

In contrast, many cyclical companies tend to perform well in a rising interest rate environment, because it often coincides with strong economic growth. This holds particularly true for the earlier stages of a rising rate cycle, when economic activity is accelerating and there are yet few signs of an overheating. Financial companies are usually considered to be the most direct beneficiaries, since their margins are expected to actually expand when interest rates are rising. Banks, for example, profit from a higher spread between the lending rates that they charge and the rates they must pay on deposits. They also tend to benefit from fewer non-performing assets, given that a strengthening economy implies that borrowers are better able to service their debt. Consumer discretionary stocks stand to benefit from the stronger economic activity associated with a gradual increase in interest rates as well. Better employment conditions and a healthier housing market typically strengthen consumer confidence and thereby induce higher spending on durable goods, leisure as well as luxury goods and services.

One could in turn argue that the defensive stocks should underperform cyclical stocks in a rising rate environment. However, as the rate cycle progresses and analysts lower their earnings estimates in anticipation of a cooling economy, the relative performance is likely to reverse as some investors tend to shift into defensive sectors (e.g. household goods and healthcare).

Reality check

The preceding discussion points to the challenges that equity managers face in forecasting the likely impact of rising rates on equity prices, and underscores the need for a differentiated assessment of each rate hike within its economic context. This holds particularly true at this point in time, where economies have moved into unchartered territory following the global financial crisis with the massive global monetary expansion, global deflationary pressures, and falling commodity prices. Adding to the divergence from regular economic trends, and therefore the complexity in gauging market movements, is the unparalleled decoupling of monetary policy and economic development in key economic regions: Whereas the FED and BOE are expected to implement rate hikes on the prospect of a normalizing economy, the ECB and BOJ will provide ongoing monetary stimulus and are not likely to raise rates in the near future considering the gradual economic recovery in both regions. As a consequence, the currency market is also experiencing marked shifts.

In the context of the United States, the expected FED rate hike should ultimately result in lower equity prices once the economic development starts to cool. However, in the near-term the rise in interest rates should not push the stock market over, albeit a higher volatility surrounding the event. The widely anticipated rate increase that is most likely to be orderly and gradual, the ongoing solid economic development in which consumers have only begun to reap the benefits of the recovery, and the absence of inflationary pressures - all support the argument for an economy that is not yet overheating. In any case, while overall market trends may be difficult to pinpoint, the varied effects of an interest rate change offer investment opportunities for stock pickers throughout the rate cycle.

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