PRUDENTIAL **INSIGHTS**

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Why equities are a wise choice in a low interest rate environment

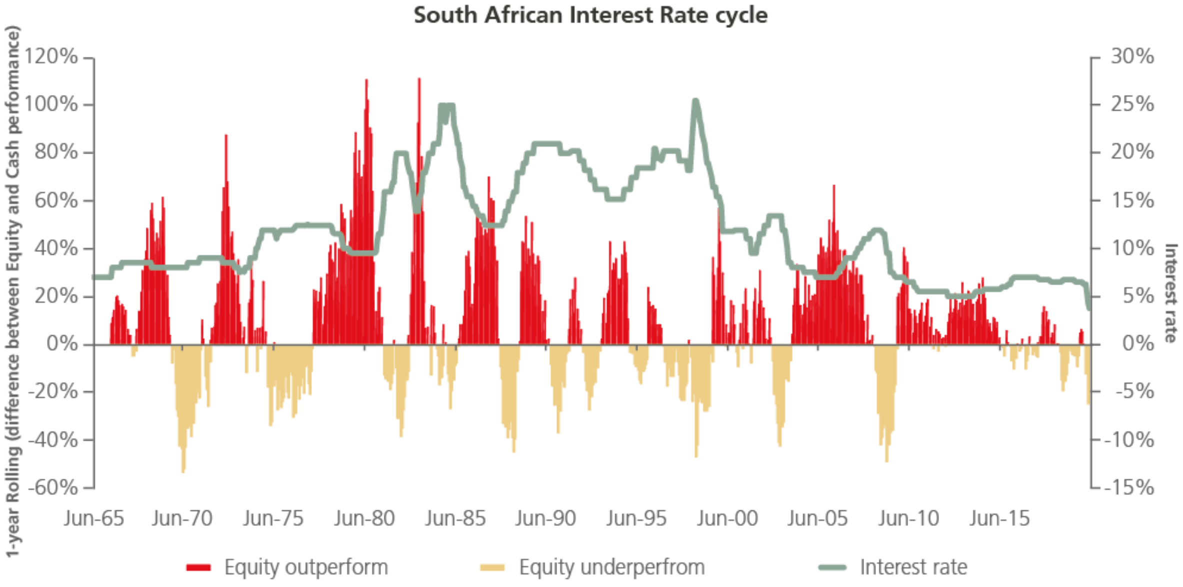
Over the past five years equity returns have been rather disappointing compared to cash, with the FTSE/JSE All Share Index returning just 4.2% (as at the end of June 2020) while cash (as measured by the STeFi Composite Index) returned 7.2% over the same period. Exacerbating the poor equity returns was the Coronavirus sell-off in the first quarter of this year, which saw equites lose 21.4% in just three months.

Investors have been understandably worried about investing in equities in this highly uncertain environment, and many are taking the “safer” option by staying in cash. But the environment in which we find ourselves has changed dramatically since the start of the year -- interest rates have decreased substantially and the prospective returns from equites are looking significantly better compared to cash.

To demonstrate why we believe opting for cash is likely to be an unwise choice for long-term investors, the below graph shows how equities have historically outperformed cash in times when interest rates are low, back to 1965.

Financial Market Behaviour

South African Interest Rate cycle



Source: IRESS to 31.03.2020

Looking at the graph, we can see how the interest rate (grey line) has risen and fallen over time, depending on SA's economic cycles. In periods of rising interest rates, such as in the late 1990s and more recently in 2007-2008 before the Global Financial Crisis (GFC), equity returns underperformed those from cash investments (as shown by the gold bars below the 0% line). This is largely because companies find it more costly to generate profits and consumer debt is expensive, making it tougher to generate strong equity returns, while bank deposits and money market funds pay higher interest rates.

Conversely, when interest rates are falling, such as after the GFC, equity returns outperform those of cash (as shown by the red bars above the 0% line). In this downcycle, companies and consumers are able to borrow more easily and generate economic growth, helping to stimulate the economy, and equity returns solidly outperform cash investments.

Based on this historic pattern, we could expect equity returns to start to outperform cash returns. The SA Reserve Bank has slashed interest rates by 250 basis points in the past four months, putting them near historic lows, so that returns from cash investments are not likely to deliver above-inflation returns going forward. In the current environment, equities are likely to be a "safer" option for longer-term investors than cash in terms of their expected returns.

To find out more about our equity funds, visit the Our funds section of our website. Alternatively, if you’re ready to start investing now, you can do so online in under 10 minutes by completing our online application form. For more information, please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.