Table Talk

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Key take-aways

- As interest rates rise, consumers can expect to pay more for their debt, while investors should receive higher returns for cash investments. However, with interest rates starting from a record-low base, it may be some time before cash delivers above-inflation returns.
- Both nominal bond and equity returns are typically lower in a rising interest rate environment, negatively impacting on corporate profitability and government balance sheets. However, there are opportunities in assets that trade below their long-term fair value, such as select SA equities and bonds currently.

Q **The South African Reserve Bank has just increased the interest rate by 0.25%. What does that mean for me as a consumer and how will it impact my investments?**

A Changes to the interest rate can have a major impact on the financial position of most ordinary South Africans, from the amount that they pay towards their debt-financed purchases, to the investment returns that they receive from certain asset classes like nominal and inflation-linked bonds, and cash-type investments. Understanding how it all comes together is important for consumers and investors alike, as it can help them make better-informed decisions regarding their finances and investments.

But before we begin, it's a good idea to first understand where we are currently as an economy, where we've come from, and how the South African Reserve Bank (SARB) uses interest rates to manage inflation.

How the SARB uses interest rates

Interest rates typically work in cycles and are used as a mechanism for central banks to control inflation (the rate at which the cost of goods and services increases) over time. As we entered the Covid-19 pandemic, with the subsequent closure of certain parts of the economy many South Africans lost their ability to earn an income, and consequently, participate in economic activity. This placed downward pressure on the economy as a whole. To help relieve some of the financial pressure on consumers, businesses and other market participants, the SARB began reducing rates to the point where they reached their lowest levels ever in July 2020 and remained at this level until November 2021. During this time, indebted consumers were able to take advantage of this by paying off their debts, borrowing more, and contributing towards overall economic growth. Investors, however, received exceptionally low returns from their short-term investments, not even enough to beat inflation.

As the economy began reopening and employment levels increased, consumer spending continued to accelerate, but producers were slower in gearing up their supply chains, resulting in a rise in inflation from around 2.1% p.a. at the start of the pandemic to 5.0% p.a. where we are currently. Higher prices have been particularly evident in energy supplies like oil and natural gas.

To ensure that inflation remains within its target range of between 3-6% p.a. the SARB increased interest rates moderately by 0.25%, for the first time in three years, at its latest monetary policy meeting. Most economists agree that the SARB's decision was a necessary one in light of rising inflation, and shouldn't be a cause for concern. That said, consumers and investors may experience some level of discomfort (especially given the record low levels from where we come), most of which can be mitigated by having a good understanding of the effects of an interest rate hike.

Impact on consumers

When interest rates increase, loan repayments become more expensive as the rate at which the interest component of the loan is calculated rises. This isn't good news for anyone with high levels of debt, especially if you took on more debt when interest rates were at their lowest. If you could just about afford to make your repayments then, you may now find yourself struggling – especially if rates were to increase more. Given that the SARB's own forecasting model indicates a further 0.25% increase in each quarter of 2022 and 2023, now may be a good time to reduce your high-interest debts as far as possible. Or at the very least, not assume any new debt unnecessarily.

Impact on investments

Cash investments usually benefit from interest rate hikes, as banks usually pass on the SARB's increase by raising the amount investors can earn from call and fixed deposits. However, the interest rate that investors are likely to receive may still be lower than inflation, which means that the real rate of return from a cash investment will still be negative (and may remain this way for a while).

When it comes to equities, higher interest rates have a negative impact on company earnings and stock valuations. In terms of earnings, borrowing costs in the form of interest payments become more expensive, while consumer spending slows down. The combination of higher costs and a reduction in sales results in lower revenue, so the company becomes less profitable. From a valuations perspective, investors value a company by using a discount rate to calculate the present value of its future cash flow, also referred to as the Discounted Cash Flow method. When applying this valuation methodology, increases to the interest rate result in a higher discount rate, which essentially reduces the present value of that company's future earnings, and consequently, the price that investors are willing to pay for that stock.

Bonds and other fixed-income instruments follow a similar valuation approach. When investors determine the present value of a fixed-income instrument in terms of its future coupon payments, they also apply a discount rate. Similar to equities, higher interest rates have an inverse relationship when determining the present value of future income payments, thereby lowering the valuation of that bond or other fixed-income instrument. In addition, newly issued bonds entering the market will typically offer investors a higher coupon rate, in so doing making previously issued bonds with lower coupon rates less attractive.

Inflation-linked bonds are usually more sought-after by investors in a rising inflation and interest rate environment, as they offer built-in protection against inflation. Their coupons are adjusted higher or lower on a regular basis over time, based on the changing inflation rate.

It's important to remember that markets are forward-looking and that expected changes to the economy and financial markets are already taken into account well before an actual interest rate hike or cut when assessing the prices of assets. Markets typically only have extremely adverse reactions to large-scale unexpected events or shocks, such as the Global Financial Crisis in 2008, or more recently, the partial closing of the economy due to the Covid-19 pandemic. While it's very difficult to plan for such events, at M&G Investments we strive to build well-diversified portfolios for our clients that account for a wide range of outcomes and that are resilient against broad changes to the economic landscape, thereby reducing downside risk while diversifying the potential for returns.

"...cash has historically been the lowest-performing asset class over the long term..."

In conclusion, despite the SARB raising the repo rate by 0.25%, interest rates are still exceptionally low relative to their history, which makes it a good time to reduce your high-interest loans as far as possible. The returns from cash investments may become appealing if interest rates continue to rise, but we would urge against going this route given that cash has historically been the lowest-performing asset class over the long term, with the lowest potential for long-term outperformance.

If you are looking to add to your portfolio, a better option would be to look out for investment opportunities that are trading at discounted valuation levels and that have significantly better long-term growth potential, such as a good equity fund. Another sound option would be to simply add to your existing portfolio and allow your chosen fund manager to adjust the asset allocation within your portfolio based on their assessment of future returns. One of the benefits of going this route is that if you are invested with a fund manager such as M&G Investments, which has a long-standing track record and the backing of a global investment brand, you'll gain access to a broad range of investment opportunities both locally and offshore, thereby reducing risk while enhancing your investment return potential. □

Pieter joined M&G Investments in 2015 as Managing Director of M&G Investments Unit Trusts and Head of Retail Business. In 2019 he was appointed as Chief Client & Distribution Officer. With 23 years of industry experience, Pieter previously worked for one of the country's largest financial services groups in a range of senior management positions. He holds a B.Comm (Maths) degree from Stellenbosch University, and is a Fellow of the Institute of Actuaries (UK) and the Actuarial Society of South Africa. He completed the General Management Program at Harvard Business School in 2010 and during 2020 completed a course in Behavioral Finance from Duke University.