M&G Insights

M&G Investments

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The impact of rising interest rates on your money and investments

Earlier this month, the South African Reserve Bank (SARB) raised its benchmark repo rate by 75bps to 6.25%, marking the sixth consecutive hike since November last year, and not likely to be the last in 2022.

Although most economists will agree that these rate hikes have been a necessary measure to help curb inflation, the reality is that changes to the interest rate can have a major impact on ordinary South Africans. Understanding how it all works is therefore important, as doing so can not only help you make better-informed decisions about your finances, but also help you maximise the returns from your investments. Here we take a closer look at some of the main points that you should consider when it comes to rising interest rates, your money and your investments.

How the SARB uses interest rates

Interest rates typically work in cycles and are used as a mechanism for the SARB to control inflation (the rate at which the cost of goods and services increases) over time. To ensure that inflation remains within the SARB's target range of between 3-6% p.a., the Reserve Bank either decreases or increases interest rates to support or moderate economic activity, which in turn has a direct impact of consumer spending, and consequently… inflation.

The recent spike in inflation has largely been in line with increases seen across the globe, brought on by supply disruptions following Russia's invasion of Ukraine. Prior to this, global economies were already dealing with elevated levels of inflation (albeit to a lesser extent) due to an uptick in economic activity as the world lifted many of the remaining Covid-19 lockdown restrictions, and various governments introduced fiscal stimulus measures to help spur economic growth. Most central banks were therefore already on a rate-hiking path leading up to the Russia-Ukraine war, which they then accelerated to help curb the rapid rise inflation.

Assuming the SARB continues with its current rate-hiking cycle, headline CPI is expected to retreat to 6.5% in 2022 before edging lower to 5.3% in 2023, back to within the SARB's target range. Whether or not the forecasts pan out as expected, consumers and investors may experience some level of discomfort as interest rates continue to rise.

Impact on consumers

When interest rates increase, loan and bond repayments become more expensive. This is because 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 could just about afford to make your repayments when rates were lower. If you find yourself in this position, 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 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.

Investors typically value a company by using a discount rate (also referred to as the Discounted Cash Flow method) to calculate the present value of the company's future cash flow. When applying this methodology, interest rate increases 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.

Fixed-income instruments follow a similar process. When investors determine the present value of a fixed-income instrument, they also apply a discount rate to future coupon payments. 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. This makes previously issued bonds with lower fixed coupon rates less attractive. Meanwhile, 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 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. Markets typically only have extremely adverse reactions to large-scale unexpected events or shocks, such as the Russia-Ukraine war. 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.

As a concluding thought, the returns from cash investments may become appealing if interest rates continue to rise, but we would caution against going this route given that cash has historically been the lowest-performing asset class over the long term. 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. 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.

For more information on investing with M&G Investments, please feel free to contact our Client Services Team on 0860 105 775 or email us at info@mandg.co.za.