



PRIVATE FUND
MANAGEMENT



STAY ON TOP

OF RISING INTEREST RATES

In the years since the financial crisis hit in 2008, the defining feature of the global economic environment has been the response of the world's central banks. The resulting low interest rates and extra liquidity for equity and bond markets have been important drivers of investment returns but they have also led to changes in investors' behaviour – for example, people taking on more risk in a bid to boost their income.

This period looks to be drawing to a close. With economic growth gaining momentum in the UK and the US, central bankers in both countries are pondering the speed and scale of

future interest rate rises. Admittedly, gloomier outlooks in the eurozone and Japan mean policymakers there continue to follow a different path but it is still well worth thinking carefully about the potential effects of rising interest rates on your personal finances, including investments and mortgage payments. Thus far, global monetary policy has arguably most affected currency markets, with moves in the dollar-sterling exchange rate greatly influenced by the prevailing view as to which country will be the first to raise rates. For their part, equity and fixed income markets have broadly absorbed the gradual tightening of monetary policy where it has occurred. The US Federal Reserve's announcement in 2013 that

quantitative easing would be scaled back or 'tapered' did provoke some initial weakness but subsequently shares and bonds bounced back.

As the possibility of interest rate rises comes closer to being a reality, however, these markets are likely to find it harder to shrug off the effects. As this guide explains overleaf, higher interest rates can impact different asset classes in different ways and, while any increases are expected to be gradual and limited – meaning there is less need for speedy or dramatic action – investors should now be factoring the prospect of such a significant switch in monetary policy direction into their financial planning.



HOW RISING RATES CAN AFFECT DIFFERENT ASSET CLASSES

Although rising interest rates are likely to have an impact on most individual investment portfolios, they carry both threats and opportunities – posing difficulties for some asset classes while providing ammunition to others.

BONDS

Bonds are in the front line whenever interest rates rise but the impact will vary considerably with the type of bond. At one end of the spectrum, developed market government bonds are the most exposed; at the other, floating rate notes would be a beneficiary of rising rates.

The longer a bond's life, the more its price is vulnerable to changing interest rates. Also, the lower a bond's coupon (the less it yields on an

annual basis) the more rates will have an impact. The situation may be further muddled by market liquidity – that is, the ease with which an asset can be bought or sold – as this may exaggerate any falls in price.

Government bonds: Government bonds are usually most exposed to rises in interest rates. At its simplest level, if a bond has a life of 10 years, say, and interest rates rise by 1%, its yield is 1% less valuable each year. For longer-term bonds, the impact is more severe. This has led to some apocalyptic predictions for the long-dated gilt (UK government bond) market should interest rates rise, with some experts suggesting it may see double-digit falls.

This is plausible, but it neglects the extent to

which interest rate rises may already be priced into bonds. Interest rate rises have been well-flagged by policymakers and only a surprise in the speed or extent of the rises is likely to seriously wrong-foot markets. Either way, developed market government bonds are likely to struggle in a climate of rising rates and may not provide the relative security of income and capital return that investors have traditionally associated with them.

Corporate bonds: With corporate bonds, a greater proportion of their price relates to their credit risk and therefore they are less sensitive to rises in interest rates – particularly at the higher-yield end of the spectrum. That said, the situation has been made more difficult to predict by the scramble for higher-yielding assets created by the poor returns available on cash. This increased demand means the income available is now at historic lows, as is the amount investors are paid over and above government bonds. This does not suggest strong returns for investors from corporate bonds in future and particularly in a climate of rising rates.

Weak liquidity in corporate bond markets may create further problems following a rise in rates. If it prompts a significant sell-off in the asset class, the market – which remains relatively illiquid – may struggle to cope with the exodus. This may push prices down further than normal valuation metrics would suggest.

EQUITIES

Interest rates are only likely to rise when policymakers believe that economic momentum is sustainable and wage growth is

SAVINGS RATES

Any rise in interest rates will be welcomed by savers, who have had a lean time of it over the past few years. Having reached a recent peak of 5.75% in July 2007, interest rates – from which deposit rates generally take their lead – rapidly plummeted to an all-time low of 0.5% in March 2009, where they have since remained.

Cash rates should move higher although they are unlikely to reach a point where, once the erosive effects of inflation are taken into account, they generate a significant income over the longer term. The top easy access cash rates remain below 2% while, in recent years, inflation has tended to remain in the range of 1.5% to 2%. Savers may no longer be losing money in real terms but they are unlikely to be making significant returns either. The long-term necessity of moving into riskier assets such as equities or bonds to generate a meaningful income remains in place.

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well-established. Such an environment should be supportive of equity markets in general. Historically, stockmarkets have tended to display volatility as interest rates start to rise but associated improvements in corporate earnings have usually translated into stronger share price growth.

That said, the situation is likely to affect different types of equities in different ways. To date, the greatest impact from the threat of rising rates has been seen in two areas – emerging markets equities and the so-called ‘bond proxies’.

Following the US Federal Reserve’s ‘tapering’ announcement in 2013, emerging markets sold off, dramatically underperforming their developed-world counterparts. This so-called ‘taper tantrum’ was prompted by investors’ fears the diminished liquidity available in global markets would reduce flows into emerging markets and so hold back economic growth. They have since revised their view and emerging markets have once again rallied. Even so, the risk remains that reduced global liquidity slows emerging markets growth and the asset class slides once more.

In recent years, companies with reliable or predictable dividends and earnings have come to be seen as ‘bond proxies’. These sorts of stocks had become a higher-yielding, higher-growth alternative to bonds within portfolios. These qualities became less attractive as the prospect of rising interest rates loomed. Again, the share prices have since recovered but remain vulnerable when interest rates do start to rise.

Interest rate rises diminish the value of dividends. The post-crisis years have seen investors prioritise equity income over growth with UK Equity Income and Global Equity Income sector funds topping the sales charts. This has come at the expense of more growth-focused businesses and, while this is unlikely to reverse wholesale, it may tip the balance more in favour of such stocks. In the longer run, higher interest rates will



raise the cost of borrowing for companies although many have been disinclined to borrow much since the credit crunch bit and, in general, corporate cash balances remain at historically elevated levels. That said, those businesses with high amounts of debt will find it more difficult to grow if interest rates rise materially.

OTHER ASSET CLASSES

Commercial property: Commercial property is an income-focused asset so, again, the value of the income available from the asset class will become less valuable when interest rates rise. However, rental rises – on which the income from commercial property is based – are usually inflation-linked and will tend to rise with improving economic conditions. This means commercial property may be better-insulated from interest rate rises than other asset classes.

Commodities: Gold is unlikely to fare well if the US dollar shows strength – as is likely in a rising interest rate environment. However, if geopolitical risks become much more pronounced or inflation starts to rise, gold may perform better. In general, an improving economic environment – which would be the precursor to interest rate rises – has gone hand-in-hand with a more buoyant outlook

for oil and/or industrial commodities. Their qualities as a natural inflation hedge might create greater long-term demand.

Currencies: Interest rate rises are likely to blow currency markets around. Both sterling and the US dollar have already moved away from other currencies as the prospects of interest rate rises have increased. In contrast, the euro and the yen have continued to weaken. Those countries on the cusp of rate rises should enjoy continued strength but greater volatility is also likely to ensue.

Ultimately, an increase in interest rates is likely to present both threats and opportunities so it is worth taking the time to review your assets and liabilities with your financial adviser and ensure your portfolio is positioned to make the most of a rising rate environment while being sufficiently diversified to minimise the potential effects of market volatility on long-term performance.



CONSIDERATIONS FOR MORTGAGE HOLDERS

Higher interest rates may be welcomed by savers but they spell bad news for borrowers. Any rate increase will drive up monthly repayments for those mortgage holders who do not have a fixed mortgage rate and, while those who have fixed their mortgages will not feel the initial impact of a rate rise, when their fixed period comes to an end, remortgaging is likely to result in a significant increase in monthly repayments.

Lower interest rates – and, more specifically, lower gilt yields – have ensured mortgage rates have remained relatively depressed for some time now but they have dropped even

further in the years since the financial crisis. While no-one is predicting a speedy spike in interest rates – there is still too much debt around and economic growth remains fragile – bond markets will anticipate interest rate rises ahead of the event and, by the time they have risen, it may be too late to lock in lower yields.

Anyone taking out a mortgage should always assess not only whether they can afford their repayments now, but also whether they would be able to afford them in an environment of higher interest rates. Although rates are not expected to rise as far or as quickly as before the financial crisis, even a relatively small increase could have a relatively substantial effect on your monthly repayments.

If the terms of your mortgage allow, it may be worth considering overpaying on your mortgage while rates remain low. It may also be worth negotiating a new mortgage now – perhaps moving from a standard variable rate to a fixed rate.

That said, mortgage lenders are already poised to implement a rate increase once it takes effect and are therefore likely to take account of this when offering another deal. Make sure you check the terms of your current deal – you could incur penalties from your current lender if you switch to a new one – and, above all, do take expert advice.



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