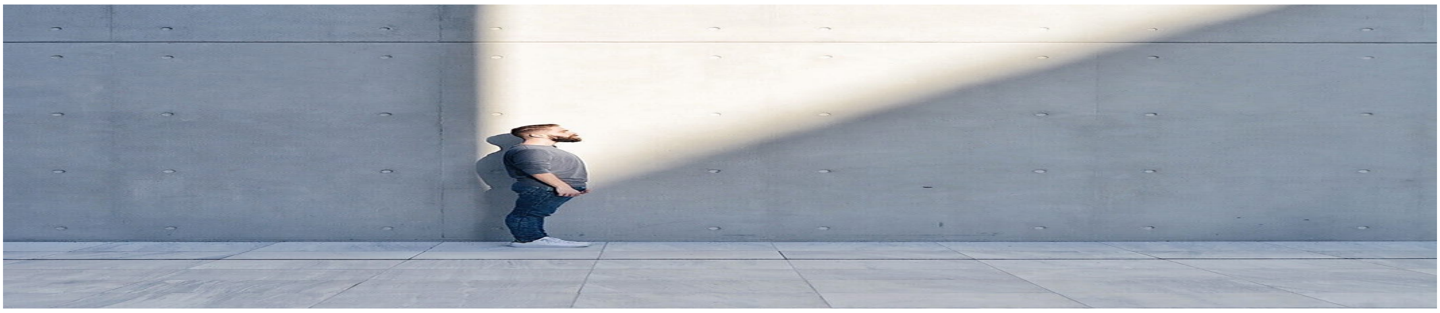

How to think about the issue of rising interest rates for investors

Published
March 8, 2021

Length
4 minute(s) read

Didier Saint-Georges, a Carmignac Strategic Investment Committee member, offers here his latest insights into financial markets, where a fair amount of turmoil is observable just when a new market environment could well be changing longer-term investor behaviour.

Investors started the year in the same chipper mood they had shown at the close of 2020, but they now seem more skittish. What's your take on this?

Didier Saint-Georges: In our **January Note**, we notably discussed the outlook for higher interest rates and warned that "market developments in 2021 may prove to be trickier than is commonly thought". The latest events have lent credence to our warning. Now that interest rates have begun to rise, investors are wondering how that will affect equities.

But once it gets going, isn't an upward trend in interest rates good news for investors?

DSG : The message that rising rates send out is usually rather positive for equities. Higher rates suggest that the economy is picking up, and initially, it isn't a major threat to companies' ability to borrow money. But those aren't the conditions we're confronted with today.

What do you mean?

DSG : To understand the current situation, we need to recall how the 2008 financial meltdown changed the economic landscape we had been used to until then. Central banks, which regulate economic activity, were forced to intervene on a huge scale to reboot the global economy. Their interventions drove down interest rates and kept them extremely low, and the same policies were pursued for a full decade.
Those low interest rates kept the stock market humming throughout the period. On the other hand, wages barely increased, economic growth was mediocre and prices practically stagnated.

And that was the strange backdrop when the Covid-19 outbreak hit...

DSG : Exactly. The recession in 2020 gave a first big jolt to public policies, as governments had previously been under pressure to keep spending down. The slump compelled them to turn sharply away from their former fiscal austerity mantra. Because they saw a need to reboot a global economy shut down in response to the pandemic, they adopted a variety of measures like financial assistance to businesses, or even money sent directly to households, as happened in the United States.
Next came the US presidential election. Bolstered by his party's majority in Congress, Joe Biden is demolishing what's left of the former economic paradigm by committing to unprecedented fiscal stimulus – a programme explicitly focused on real GDP growth and the fight against economic inequality.

It seems as if the environment for investors is in the throes of major change. Is it?

DSG : We may well be experiencing what has been called a regime shift in financial markets. Going forward, the investment environment may start looking very different from the one we were familiar with for years. This could result in deep changes in the behaviour of companies and investors alike. The stimulus programmes adopted by governments to tackle Covid-19, combined with large-scale vaccination, could lead worldwide to some of the highest year-on-year GDP growth rates since the 1980s, or in any event in the United States. But with the global economy forecast to grow at a 5% to 6% pace this year, the attitude of central bankers and how they handle interest rates remains an open question.

What risks would higher interest rates entail in the current circumstances?

DSG : If the economy bounces back too strongly, prices could shoot up. The new US administration's stimulus plans in particular make that seem likely. To prevent the economy from overheating and keep inflation in check, central banks could well raise interest rates. If that policy goes too far, it could push down share prices by encouraging investors and savers to turn instead to other financial assets offering higher returns. Furthermore, high interest rates would make borrowing money and consumer credit more expensive. So at the present time, the attitude of central banks is the key issue. The question is: when might they start tightening monetary policy – in other words, raising the interest rates they set?

Is that what's driving the turbulent state of financial markets today?

DSG : The current turmoil is due to the wait-and-see attitude so openly displayed by the US central bank – the Federal Reserve, or Fed. Investors now have some reason to fear that if strong GDP growth continues beyond 2021 in the US, the Fed might then have to drastically tighten the screws to keep the economy from overheating.
In addition, the Fed's policymakers are underestimating the economic upswing. They expect the US economy to expand by a "mere" 4.2% this year. We consider that forecast far too modest.

What is the economic outlook for the US this year?

DSG : We expect the US economy to grow quite strongly in 2021. A $1.9 trillion Rescue Plan has already been passed by the House of Representatives, and it will likely by paired soon with a similarly huge infrastructure bill. Moreover, with the United States well on its way to herd immunity to Covid-19, consumer spending can be expected to shoot up. But the US central bank somehow seems unimpressed by these various factors – at least for now.

You mentioned the Fed’s wait-and-see attitude. Yet US interest rates are on the way up, aren’t they?

DSG : In the past few weeks, real long-term interest rates – meaning interest rates corrected for price increases – have risen in financial markets, because traders believe the Fed will eventually have to take action. With US economic growth forecast to accelerate, investors expect that the central bank will lift its own key rates and also scale back its purchases of financial assets, which were initially a way of rebooting the economy by pumping cash into the system. Even so, in his testimony before the US Senate Banking Committee on 23 February, Fed Chairman Jerome Powell reiterated that he had no plans to tighten monetary policy in the near future. But by incrementally pushing up real long-term interest rates through their trading, investors are telling the Fed that there is a rising cost to not acting.

How do you deal with all this?

DSG : A market regime that has been there for years can’t be undone overnight. In this transition period, we will undoubtedly see greater volatility in share prices. But the paradigm shift under way calls for a cautious approach. And in our view, active management of savings is **the crucial ingredient**. At Carmignac, we have scaled back risk in all our portfolios in the last few weeks. Next to our reopening names, we are therefore hanging onto our portfolio of high-quality growth companies that will generate high earnings going forward and have the ability to maintain their profit margins by raising their own selling prices when costs for things like materials, wages and rent go up.

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Source : Carmignac, Bloomberg, 01/03/2021