

Stockmarket Volatility

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Investment management is a discipline founded on mathematics, however there are so few mathematical certainties within it. Rather, investors are usually dealing with probabilities; things that might happen based on our best estimates of a range of contingent variables. There is however one mathematical relationship which is fundamental; that between “price” and “yield.”

Yields move inversely to price. Yield can be thought of as the “interest rate” on an investment and the two most important rates in finance are:

1. The Federal Funds Rate, which is the rate, or price, at which the US Federal Reserve will supply dollars to the banking system
2. The ten-year bond yield, which is the rate off which a vast array of global financial products are priced. It can also be considered the “price” of the opportunity cost of investing in other investments.

Fluctuations in these yields have consequences for financial assets because changes in these yields alter the “discount rate”, which is fundamental to appraising or valuing competing income streams or investments.

A lower discount rate will raise the price of financial investments whilst a higher rate will lower the price of financial instruments specifically instruments that have a “fixed” interest rate such as UK Gilts or US Treasury Bonds. This is the reason why so much is written and speculated on in the Financial Press about “will they or won’t they” raise (lower) interest rates.

Investors can analyse the impact of changes on the price of investments in the light of expected changes in interest rates, and the impact can be surprisingly large, even on, supposedly, “safe and risk-free” assets.

What would you pay for a ten-year gilt yielding 2% maturing in 2032?

Using the base rate as your discount rate, the present value of the income stream would be £120.41 per £100 nominal. That would be the upper limit of what you would pay for that investment.

But, if the discount rate rose to 0.5%, what would be the effect on the price? It would fall to £117.45. If rates rose further to 2.5%, the price of our gilt would fall to £97.97, some 20% lower than our original price of £120.41.

Therefore, discount rates matter greatly and it is worth knowing that “risk-free” assets are not at all risk-free; it all depends on the price, especially for instruments that have fixed income streams.

What’s this got to do with stockmarkets?

Discounting future expected cashflows to arrive at a valuation is fundamental to equity or share analysis. The same terms apply, except that the future expected cashflows are variable, and, in the case of earnings and dividends, they are normally expected to rise over time. It is this that makes investing in companies rather special and rather attractive to long term investors.

We are acutely aware of these issues for two extremely important reasons.

The long decline in interest rates that began way back in the 1980s may now be over.

More importantly, due to the pandemic but also to the accelerating rate of “deglobalisation” with respect to trade, global inflation rates are rising. The Office of National Statistics (ONS) reported UK inflation at 4.8% to the 12 months to December 21; in the US inflation topped 6.8% immediately before Christmas. Even in inflation phobic Germany, inflation breached 5%, a rate unheard of for decades.

We think that the world’s central banks will tolerate higher inflation in the immediate future than they have in the immediate past. There are two reasons for this: there are good reasons to believe inflation will moderate somewhat as base effects fade and as supply-chains reopen post-pandemic. Secondly, the world is very highly indebted and cannot afford higher interest rates; moderately higher inflation rates will help stabilise real debt ratios as long as underlying growth can be maintained.

4% is the likely to be the new 2% (2% being the implicit inflation target of most independent central banks). The “flexible inflation targeting” regimes adopted by the Banks will mitigate a period of above target inflation as the Banks can argue that below target inflation in prior periods enabled them to hit target “over the cycle.” This is a reasonable position to take in our view.

Returning to the discussion of discount rates, this means financial markets will have to come to terms with higher discount rates and, in some cases, lower valuations particularly in “long duration” fixed interest and equity.

This is the reason behind recent market volatility as investors rotate out of speculative, often “non-profit making” technology companies into more traditional “value” oriented, cash generative, shorter duration assets. This volatility will persist until market participants are confident, they have “re-priced” the new outlook. Interestingly, Microsoft to us is more an old economy stock than a technology company as it has matured over the past 50 years.

We remain optimistic for equity markets and the post-pandemic recovery, notwithstanding market volatility, for two fundamental reasons. Firstly, as we have noted before consumer balance sheets are in very good shape (in aggregate) and pent-up demand remains unsatisfied and secondly, gross fixed capital formation or investment, has remained strong during the pandemic.

If discount rates are rising, we would much rather be invested in income streams that are set to rise faster than the discount rate than invest in long duration assets with fixed income streams that now look very exposed to a rising global discount rate.

Over the course of the last 18 months, we have been positioning investor portfolios towards fixed interest investments whose income streams and nominal values are variable to some degree in line with inflation, coupled with a bias towards a diversified mix of durable, quality global businesses which we feel can withstand changes to the status quo. Short term volatility is a given when investing, it is vital however that we preserve medium term purchasing power for our clients through what is a more difficult market backdrop.

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