MADISON PARK
CAPITAL ADVISORS

WEEKLY MARKET UPDATE

March 8, 2021

Why interest rates matter

A few weeks ago, I put together a piece on refinancing your mortgage that I planned to use for this month's financial planning briefing. At that point, interest rates were at record lows – with some clients getting quoted rates on a 15-yr mortgage that were sub-2% (with some points paid). Phones were ringing off the hook at lending offices and borrowers were getting their paperwork pulled together as quickly as possible. Oh, what a difference a few (read: three) weeks makes. Since then, rates have drifted higher, causing a significant slowdown in lending applications as borrowers reassess the prudence of a refi at this juncture. While I gladly still share my briefing on refinancing (link below), I decided this week's piece would be better served looking at a topic that impacts both planning decisions and market valuations – "Why interest rates matter."

I distinctly remember opening my first savings account at the local bank when I was still in elementary school. My parents dutifully explained how this magical thing called interest would accumulate, essentially giving me free money (in my mind, at least). Even better, interest would grow on that interest, meaning I would make more in each subsequent month. I was smitten with this idea. Fast forward a few months and there we were watching NBC Nightly News (yes, I was a nerdy kid…but a well-informed one!) and they were talking about excitement around interest rates dropping. Young Andrew was suddenly confused – and quite dismayed – as my view was that higher rates equaled more money for me in my little (but growing!) savings account.

How could lower rates be better? My wise parents quickly filled me in, giving me a basic understanding of how it all worked…and I admittedly have been gathering a deeper understanding of this answer ever since, through business school, an MBA, a CFP exam, as a business owner, as a homeowner, and more. Turns out interest rates do matter…a lot…so we're going to look at a few key reasons why. Admittedly, some of this is old news for many of you, but we hope you'll learn something new and gain a better understanding of why talk of rising rates has coincided with market weakness over the past couple weeks.

Lending drives economic growth

Just as most of us borrow to buy our house, small businesses and large corporations alike borrow to invest in future growth. This leverage allows them to accelerate the acquisition of equipment, technology, or intellectual capital necessary to pursue new opportunities and ideally drive future profitability upward. When interest rates are low, businesses are likely to do one or both of the following:

1. ***Borrow more*** – thus fueling the economic engine that allows the economy (and corporate profits) to grow.
2. ***Lower their cost of borrowing*** – thus sending more of their hard-earned revenue to the bottom line (profits)

As interest rates climb, both of these positives are challenged. Economic growth slows or profitability declines – both of which put downward pressure on stock prices. More on stock prices below…

Lower rates help drive housing prices

Three factors have largely been responsible for the strength of housing prices lately. Pandemic-driven demand, incredibly low inventories, and (you guessed it) ultra-low interest rates. These rates allow potential buyers to either: 1. Lower their monthly payments on an otherwise equivalent loan amount, thus making a house purchase feasible for a greater number of buyers, or 2. Afford to pay more for the same house, as that payment they had budgeted now goes further. It's no secret that homeownership is a major driver of economic growth, just as skyrocketing housing prices contribute to the "wealth effect" that can further boost economic vitality. But just as things go up, they also go down. Rising rates challenge everything I just listed.

Rates help determine business valuations (read: stock prices)

My last class at UW was on business valuations. Prof Schall was a big proponent of discounted cash flow (DCF) as the very best means of valuing a business. I loved the class and the concept stuck (I still have the materials from that class 20+ yrs later). What it says is that the financial worth of a business is equal to the present value of all future cash flows that could be obtained by the owner(s). A key in the formula that applies here is the interest rate (or "cost of capital"). A second key is the terminal value assigned (read: cash flows further out into the future). Okay, boring stuff – so get to the application, please! One reason that tech stocks, particularly those in their relative infancy (such as those owned by the now-familiar ARKK), have attracted such rich valuations in recent years, especially the past 12 months, is due to two factors:

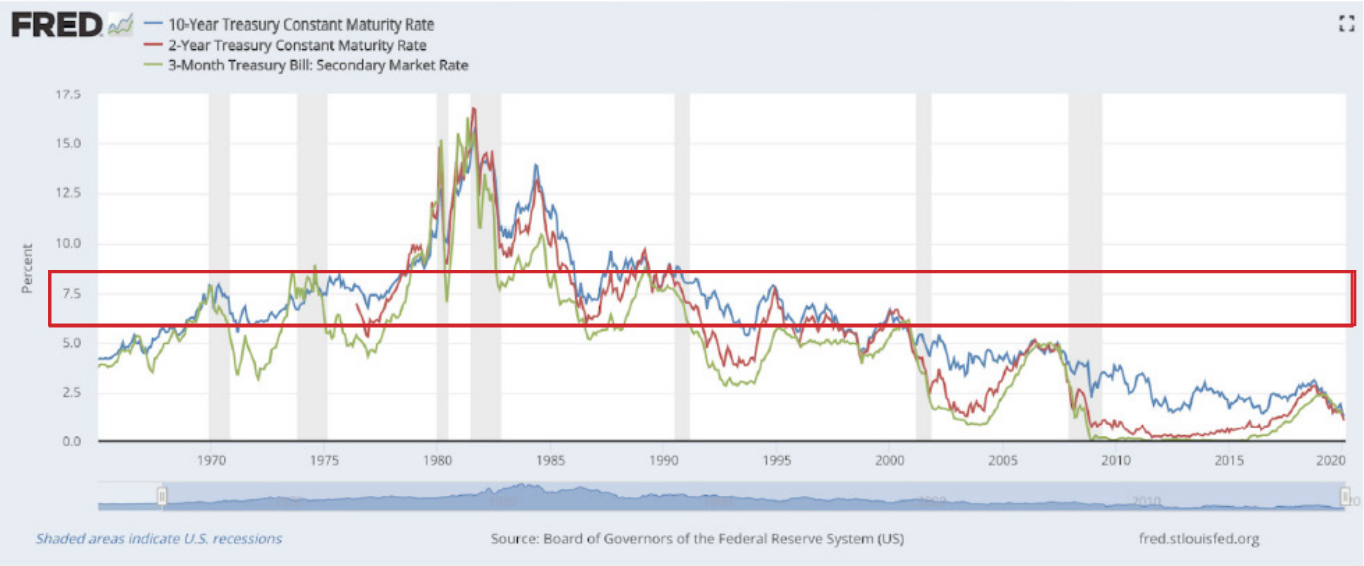
1. Most of their positive cash flows are assumed to be years in the future
2. Interest rates have been at record-lows

Sparing you the math I'll say this – these two factors combine to drive up the discounted cash flow valuation of high growth companies that are currently operating in the red but that have

bright outlooks down the road. Now enter the past two weeks, where yields on longer-dated government bonds have spiked upward. Enter these higher rates into the DCF calculations for any business and you will quickly see the valuation of that business drop, oftentimes quite significantly. The key here for an investor is to know that not all companies are impacted equally, so these changes can actually improve the relative valuation of other firms, many of which have been forgotten in the run up of the sexy growth names.

Interest rates help determine if we're savers or investors

It used to be that you could save $1MM, retire, put most of that money in investment-grade bonds earning 6-8% (or more), clip off $60-80k/yr in interest with little to no risk to your principal, and enjoy a comfortable, stress-free retirement. Here's a chart of yields on (risk-free) government bonds over the years. Other bonds largely follow suit, but offer higher interest rates (of varying degrees). I put a box around the 6-8% range for reference.



Gone are those days! Now you are hard-pressed to get 4% from a portfolio of junk bonds! Being a saver is tough...whether you are a retired saver or a young one like I was in the story above. So we're left with two options:

1. Save a **LOT** more than prior generations.
2. Take a **LOT** more risk.

Those of you in retirement know that #1 is not an option, unless going back to work is something you desire. That means #2 is the rabbit hole you have to go down. We've talked about it before – TINA (There is no alternative). This concept is that savers are suddenly forced to be investors, pushing them into the markets, creating more demand, and thus driving equity prices higher. So, what happens when interest rates go up? You guessed it, the marginal need for equities declines. If you have a target of 6% per year from your portfolio, and you can suddenly get closer to that target via risk-free or lower-risk assets, you are going to go there. Less demand for equities then means lower prices for those equities. It can happen quickly.

So, what are we watching for? Will these "growth" stocks continue to descend, or will they regain their footing? As you may have guessed by now, it will largely come down to where interest rates head in the near future – and why. Higher rates may have negative implications, but the breadth and depth of these implications depends on the why. Are they rising simply because of expectations of inflation or because of expectations of economic growth? Ultimately, interest rates are driven by a number of forces, simplified as "the market" and "the Fed." These two primary forces are sometimes at odds – though we have all seen that the Fed usually wins when it wants to. Will the Fed, which controls the front-end of the yield curve (meaning short-term interest rates), find it necessary or wise to exert their influence on the long-tend of the yield curve (e.g. 10-yr bonds)? Last week, Chairman Jay Powell essentially said "not yet." If this answer changes, growth stocks will undoubtedly see a resurgence. Gold will likely spike in value. The US dollar will weaken. Inflation will heat up. And the phones at the mortgage office will again ring off the hook!

Be prepared for that time by reviewing our piece on refinancing! (**Click here**)


Refinancing a Mortgage

DISCLAIMER

Madison Park Capital Advisors™
Independent Trusted Personalized