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Demographic developments suggest that persistently low rates may be more of a lasting structural issue. As Baby Boomers age, they shift towards increased safety for their life savings. Photo: iStock

What do low and negative interest rates mean for equities?

One of the biggest puzzles in finance is determining the implications of negative interest rates. Some of the world's largest economies have already moved their interest rates to below zero and more quantitative easing (QE) programs are likely to follow. Aside from the recent hawkish comments from the Federal Reserve, significant stimulus moves have come from ECB president Mario Draghi, with expansionary efforts likely coming from Japan and China. On the surface, it does not take much for low to zero rates to turn negative, but the implications for asset valuations are enormous and challenge conventional logic. We find that persistently low rates coupled with signs of real economic growth imply a potential significant rally in those companies that can demonstrate sustainable future cash flows.

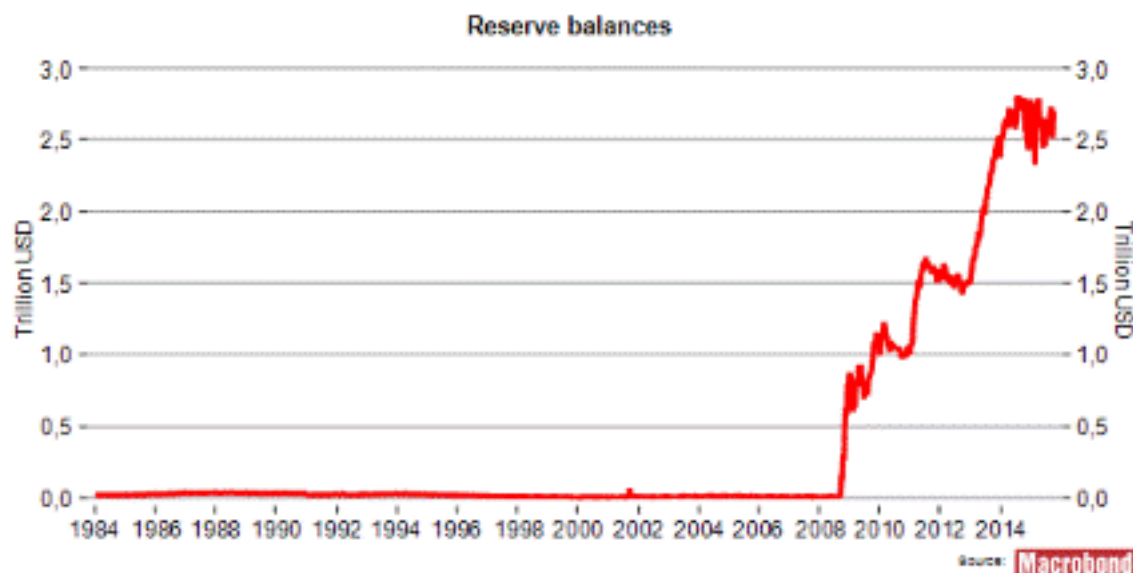
Paying to park your cash

Today, investors in Switzerland who wish to park their cash have to pay for the privilege. Not for one year, not even for five years, but all the way out to ten years. Switzerland is not alone. Currently approximately 80% of 2-year Eurozone bonds have negative yields and roughly 50% of 5-year bonds.

Why would anyone pay to park their cash? Surely, this flies in the face of traditional economic theory. Theory has it that even in the rare case of negative nominal interest

rates, the rates cannot remain there for long, because savers and investors will begin to hoard cash and store it themselves. This behaviour creates a "zero bound", forcing rates back up into positive territory. Recent events have put this assumption into question, however; is it more than an aberration and rather a sign of an unfamiliar and potentially hazardous trend?

Demographic developments suggest that persistently low rates may be more of a lasting structural issue. As Baby Boomers age, they shift towards increased safety for their life savings. That means selling risky assets and going into cash, while accepting to pay a storage fee for safety. Like consumers, companies put a premium on safety. With slowing growth rates and compressed commodities prices, companies are cutting expansion programs, with tepid private sector borrowing as a result. Commercial banks, on their part, have more money than they need. Current US reserves stand at a whopping \$2.7 trillion compared with a historical average of \$19 billion pre-financial crisis (Graph I). Banks therefore have little incentive to offer higher rates to attract or keep customer deposits. This trend will continue to keep interest rates low.



Graph I. US Reserve Balances 1984-2015

At the core, a negative interest rate attacks the fundamental principle of financial theory: a dollar today is worth more than a dollar tomorrow. Theory and intuition tell us that the future is uncertain and investors have to be compensated for the risk of waiting. A negative interest rate changes all that, however, implying that the future is more certain than the present, a paradoxical statement of gargantuan proportions. No doubt this revolutionary idea could ensure full-time employment for generations of philosophy graduates and psychiatrists. But how, if at all, does it apply to investing in equities?

Theoretically, lower rates should boost the value of equities as future cash flows translate into a higher net present value when lower discount rates are applied. Similarly, with rates close to zero, present values should spike towards infinity. In contrast, as soon as rates flip over into negative territory, equities become worthless. However, global stocks are today worth \$65 trillion, so investors must be looking at other valuation measures.

Risk matters

Logic and intuition tell us that riskier investments should have a higher expected return than safer investments to be considered a good alternative. This also forms the foundation of the Equity Risk Premium (ERP); a measure of the excess return above the risk-free rate that equity investors require to take the risk of investing in the stock market. The implied ERP is 4.25% for US stocks, broken down into the earnings yield of 6.25% less the risk-free rate of a 2.0% 10-Year US Treasury bond. If rates go lower, this should trigger a substantial reduction in ERP to around 2.0%, which implies a normalised P/E of 25x or a more than 50% rally in US just to get to 'fair value'. Similar re-ratings can occur in other equity markets around the world.



Source: Shiller: Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, updated

Graph II. Historical Equity Risk Premium - US

In reality, low interest rates are a mixed blessing for stocks. Compared to bonds, low rates by themselves make stocks a more attractive investment alternative to bonds. If the underlying reasons for low rates are low inflation and low real growth, however, they will have an impact on future cash flows, which can partially or completely offset the benefit of low rates. Today, there is evidence that real economic growth is picking up in several key markets. A world of real economic growth coupled with low inflation would be the best of both worlds, driving up the value of both stocks and bonds. In this environment, low to zero interest rates become less of a theoretical exercise and more a reality. The ultimate winners will be those companies with sustainable profit growth potential.