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Multi-Asset

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What will high interest rates mean for investors?

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Equities offer strong returns for investors who want to beat inflation

Central banks in the UK, Europe and US have made it clear that interest rates may have to stay higher for longer than many have expected so far to tackle stubborn inflation.

The soaring inflation resulting from supply shocks caused by Russia's invasion of Ukraine early in 2022, especially in relation to energy and key commodities such as wheat, has subsided. Indeed, markets rallied in November on the prospect of interest rate cuts early in the New Year.

But last month Andrew Bailey, Bank of England governor, and European Central Bank president Christine Lagarde, both insisted inflation continued to pose risks, while Federal Reserve chairman Jay Powell warned markets should not be misled by encouraging price data and that the fight against inflation still has a long way to go. If they are right, what will this mean for investors?

Higher interest rates can be financially damaging for homebuyers with mortgages, but they are positive for those in savings accounts. If rates are to stay higher for longer, then this will make savings accounts more attractive for a longer period.

Investors should compare savings rates with inflation, however: if the rate they receive is less than the current 4.6% inflation rate,[1] then the 'real' value of their wealth – the interest rate less inflation – will diminish over time.

Bonds can offer an alternative to cash

Investors looking to beat inflation over the longer term might wish to look at other types of assets, such as bonds and equities.

Bonds, also known as fixed income, are IOUs issued by governments and companies. Some market commentators say high current interest rates present an historical opportunity to invest in bonds.

Bond prices usually fall if interest rates rise, so if investors buy them now they can lock in high rates of income. If interest rates fall in the future, then this can push up the value of bonds they might hold, too.

The income from bonds reflects the levels of interest available on financial assets elsewhere in the market and the creditworthiness of the borrower.

The interest paid on several government-issued bonds such as US treasuries have touched multi-year highs recently, while UK government bonds, or gilts, were offering 4%-plus with two years to maturity in November.[2]

We are particularly positive towards the bonds issued by UK companies with higher credit ratings. The extra interest they pay compared with government bonds offers good returns for the additional credit risk. The interest rates available also compare favourably to cash savings rates because of this higher risk.

However, it is important to select bonds from good quality companies – an economy with higher interest rates can pose greater difficulties for companies with less financial strength. As such, using investment funds that offer diversification and that are run by managers who avoid companies and governments they see as being at risk of defaulting can be a wise approach.

Bonds that have longer terms to their maturity – when the principal must be repaid – also tend to pay higher rates of interest because of the greater uncertainty risk. Higher rates of interest are now available on longer term bonds and again, choosing fund managers who know how to navigate the risks and reap greater rewards can be a wise approach.

Equities offer strong long-term returns

If investors want to beat inflation, then equities, or the stocks and shares listed on stock markets, offer strong returns over the longer term, but they are significantly more volatile than cash. Although some companies do fail, historically, stock markets have proved to be highly successful at generating inflation-beating returns.

Equities have outstripped inflation in most of the years between 1990 to 2023, sometimes by 100% or more.[3]

Companies are seen as having an in-built defence against inflation because they can seek to pass increasing costs onto consumers by raising their prices, although this does depend on the market power they wield.

Higher interest rates still pose problems for equities though. They can mean more costs for companies, especially those with debts, which will reduce their profits. This tends to be a more significant problem for smaller companies, so they are hit harder when interest rates rise. If higher rates dampen the wider economy, then this can also reduce companies' revenues more generally.

Higher interest rates also reduce the relative attractiveness of companies' dividends. If investors can earn substantial returns in other, lower-risk investment vehicles, such as cash deposits and bonds, then there is an incentive to divert at least some investments into them from equities, driving down share prices.

Companies that promise to grow first then deliver dividends later, or 'growth-style' companies, are negatively impacted more by higher interest rates than 'value' companies that are already delivering dividends because of the discounting effect.

The UK stock market is skewed towards 'value' stocks that pay dividends more regularly, such as energy utility companies and banks, but several of the US technology giants promise returns further into the future and are more vulnerable to higher interest rates.

Enhancing investment returns

Although cash savings rates might seem to be attractive given higher for longer interest rates, the current levels of inflation imply that investors should consider alternatives. Cash can play a role in stabilising portfolios, but diversifying into assets such as equities and bonds can enhance returns over the longer term. Higher for longer interest rates do pose headwinds for equities and bonds, but much of this looks priced into markets and now could be a good time to invest for the longer term.

[1]Source: Office for National Statistics/FT, 15 November 2023

[2]Source: www.ycharts.com, 13 November 2023

[3]Source: Bloomberg, June 2023

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For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested.

The Funds and Model Portfolios managed by the Multi-Asset Team may be exposed to the following risks:

Credit Risk: There is a risk that an investment will fail to make required payments and this may reduce the income paid to the fund, or its capital value. The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay;

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss;

Liquidity Risk: If underlying funds suspend or defer the payment of redemption proceeds, the Fund's ability to meet redemption requests may also be affected;

Interest Rate Risk: Fluctuations in interest rates may affect the value of the Fund and your investment. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result;

Derivatives Risk: Some of the underlying funds may invest in derivatives, which can, in some circumstances, create wider fluctuations in their prices over time;

Emerging Markets: The Fund may invest in less economically developed markets (emerging markets) which can involve greater risks than well developed economies;

Currency Risk: The Fund invests in overseas markets and the value of the Fund may fall or rise as a result of changes in exchange rates.

Index Tracking Risk: The performance of any passive funds used may not exactly track that of their Indices.

Any performance shown in respect of the Model Portfolios are periodically restructured and/or rebalanced. Actual returns may vary from the model returns.

The risks detailed above are reflective of the full range of Funds managed by the Multi-Asset Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.

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