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Rising interest rates, value investing, war in Europe: key questions answered

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It's a chaotic time for institutional investors.

Between rising inflation and interest rates, war in Europe and an ongoing global pandemic, stock market volatility is on the rise. For those concerned about the long-term implications of these developments, here are my answers to a couple of common questions.

- **Stock markets have risen in past interest rate cycles, so why should institutional investors worry about rising interest rates now?**

Historical evidence shows stocks have risen an average of nine per cent per year during Federal Reserve bank tightening cycles since the 1950s. On average, stock markets have risen in 11 out of the 12 episodes. It was only during the 1972-1974 period that the stock market declined. Averages, however, can disguise the real culprit behind stock market performance.

n in on what investors should expect in 2022

clear stock markets have risen in most tightening Fed cycles, but the devil is in the details. Year-to-year, performance depended not only on the level of interest rates but also — and most importantly — on whether the yield curve was negatively sloped or not. For example, in the 1967-1969 rising interest rate cycle, the S&P 500 rose overall. In 1969, however, the stock market fell by 8.24 per cent. This was because rates, including the one-year treasury rates, rose from 5.69 per cent to 7.12 per cent and, at the same time, the yield curve became negatively sloped by 45 basis points. This wasn't the case in the previous years.

In 1972-1974, the overall market declined because, in 1973 and 1974, the slope of the yield curve turned negative by 47 basis points and 64 basis points, respectively. When rates rose from 4.95 per cent in 1972 to 7.32 per cent in 1973 and 8.20 per cent in 1974, the index went into a sharp fall.

From 1977-1981, the S&P rose over the whole cycle of rising interest rates, but in 1981 the market declined by 4.70 per cent as again the yield curve turned negative by 88 basis points in the middle of a rising interest rate environment.

So what will be the effect of the current Fed tightening phase on stock prices? In my opinion, gradually rising interest rates may not be a threat to the stock market as long as the yield curve continues to be positively sloped.

Read: Institutional investors eyeing increasing interest rates, looming inflation: webinar

Currently, not only are interest rates rising, but also the yield curve is starting to flatten out. For example, the 10-year treasury minus the two-year bond yield was 160 basis points at the end of 2020. It fell to 60 basis points in mid-February and it's now down to about 20 basis points — not negatively sloped yet, but given the expected aggressive tightening by the Fed, a negatively sloped yield curve is not out of the realm of possibilities within the next few months.

- **Value stocks have performed well in recent months in the face of higher interest rates, but will that continue?**

Over the last 40 years, the world has experienced a bull market in stocks, bonds and real estate due to low inflation, low real interest rates and the expansion of globalization after the fall of the Berlin Wall and the end of the Cold War. Rising inflation, increasing real interest rates and de-globalization prompted by the start of a new Cold War will augur in a predictably bleak outlook for the stock, bond and real estate markets. The markets have yet to discount this outlook.

In other words, many structural and secular changes are taking place regarding not only inflation and real interest rates, but also globalization and geopolitics. We are at an inflection point of world history with serious consequences for world stock markets and the global economy.

Read: Value investing textbook aiming to correct academic misunderstandings: author

Considering the above-mentioned secular changes taking place, growth stocks will be hurt the most. Multiples like price-to-earnings and price-to-book are negatively related to inflation, real interest rates and a positively related to growth. There will be a multiple contraction given these structural changes taking place in the economy. De-globalization will adversely affect growth stocks. In a high interest rate environment, investors will tend to avoid high-multiple — growth — firms and be more attracted to low multiple — value — firms. Since historically, interest rates are low when expected inflation is low and vice versa, this denotes one way in which inflation affects valuations.

Let’s now look at the evidence regarding the historical performance of value and growth stocks in different inflationary periods.

liers, we decided to focus on median value premiums of U.S. stocks
oping rolling 10-year periods between 1930 and 2020. The 10-year
hest inflation were 1940-1950, 1970-1980 and 1980-1990. The median value premiums were 7.56 per cent, 9.96 per cent and 13.93 per cent, respectively. The 10-year periods with the lowest inflation were 1930-1940, 1950-1960 and 2010-2020. The median value premiums were negative 2.10 per cent, 1.98 per cent and negative 2.70 per cent, respectively.

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I also examined the annual inflation rate above which the value premium became decidedly positive. This inflation rate was about 2.5 per cent. Once inflation started to exceed 2.5 per cent, value stocks started to outperform while growth stocks did better when inflation was below 2.5 per cent. Between 1930 and 2020, there were 50 years when annual inflation was higher than 2.5 per cent (averaging 5.32 per cent) and 40 years when it was lower than 2.5 per cent (averaging 0.60 per cent). The median value premium in the first period was 11.04 per cent and in the second 2.34 per cent. It’s worth noting that it’s primarily small-cap value stocks as opposed to large-cap value stocks that drive these relationships.

In light of the above, the future should bode very well for value stocks in relation to growth stocks.

- **Investing during wars has shown to be profitable as indices have been more up than down. What should value investors do?**

Since WWII, there have been 10 major wars. The S&P 500 was down in only two cases over the following 12 months, one was during WWII and the other during the Afghan War. On average, the S&P 500 was up by about 10 per cent. Averages, however, can disguise the real culprit behind the stock market performance or lack therein during wars.

Read: **North American markets tumble as Russian forces move on Ukraine**

In my opinion, this time it may be different from historical experiences. Regime changes in the macroeconomic environment, including de-globalization and the dominance of indexes by high-tech growth stocks in prior wars, may have an adverse effect on the stock market, primarily on growth stocks. Once again, in relative terms, value stocks should outperform growth stocks.