Thoughts that count

April 2023

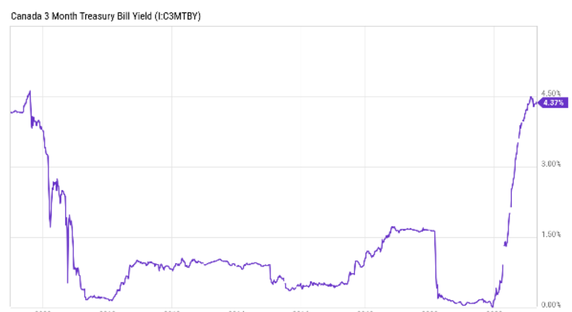
A change of course

In Europe during the Middle Ages, the primary mode of transportation involved riding on the back of a horse. A traveler never knew who they might come across, so they would always want to have unfettered access to their sword. Given most people were right-handed, travelers would want to stay to the left of any stranger passing by. Hence, a 'keep to the left' rule was adopted, and when vehicles replaced horses, the practice continued.

During his wartime efforts, Napoleon instructed his armies to use the right-hand side of the road to get around left-side travelling non-military traffic to avoid congestion. Eventually, everyone copied the military's example and took to driving on the right. Over time, the practice spread to all of mainland Europe, except for Sweden. For decades, Swedish parliament debated whether to change their driving practices to align with their neighbours. Though deeply unpopular, in 1967 the Swedish government relented, and decided to commit to driving on the right. So, at 5am on September 3rd, all Swedish roads changed from left-hand to right-hand passage. The amount of work involved with the conversion was immense; all street signs and traffic signals needed to be moved, road lines had to be repainted and an enormous public communication campaign was unleashed. The disruption this change caused was swift and dramatic.

Change is difficult, especially when behaviour has been entrenched. Switching the direction of traffic is a definitive paradigm shift. Economically speaking, last year, governments around the world made 'interest rates lane changes' in a similarly disruptive manner. The impacts have been immediate, and given our recent history of negligible interest costs, the policy change feels dramatic and punitive.

In 2007, short term interest rates in Canada averaged 4.3%. As the global financial crisis unfolded, governments around the world cut interest rates to near zero, where they stayed for 15 years (see chart to the right). Then, in 2022, because of high inflation (most of which was caused by keeping interest rates at near zero), governments increased interest rates quickly.



Sweden changing from left-side to right-side driving was a dramatic and permanent change. Drivers who didn't immediately adjust their driving behaviour faced meaningful consequences. Similarly, the recent interest rate policy changes are critical; investors must acknowledge this development as a likely permanent and fundamental change.

Interest rate changes are profound because they have a tremendous impact on future returns. All rates of return are composed of 3 parts; yield, growth and sentiment, and interest rates affect each component differently. Listed below are descriptions of each of these components, and how interest rates affect them.

1. Yield – payments made to investors who have lent or invested their money in a company or to a government. The most common forms of yield are interest payments from term deposits, GIC's or bonds, and dividends from stocks.
2. Growth – an investment will increase based on how significantly its underlying assets grow. The most scrutinized growth metric is earnings growth; if a company grows its profits, especially if they grow quickly, investment values should increase.
3. Sentiment – the least objective and most volatile component of return. Investors tell themselves stories about how and why an investment will increase or not. If a majority of investors feel positive about an asset, its value will increase. The opposite result occurs when most investors feel negative about an investment, its value will fall.

Putting each of these components together, the rate or return equation can be written; **Return = Yield + Growth + Sentiment.**

Interest rates have a direct effect on each component in this equation. The table below summarizes the effect when interest rates are lower or higher.

	Lower interest rates	Higher interest rates
Yield	Negative	Positive
Growth	Positive	Negative
Sentiment	Positive	Mixed

Yield: Conservative investments are highly correlated with interest rates. When interest rates are low, savers get discouraged as their low-risk investments options will be low yielding. They may be tempted to look for alternatives with higher growth or positive sentiment. Over the past few years, as rates have fallen to zero, many conservative investments produced no yield at all. When interest rates are high, conservative investors are content as their assets attract significant yield, without the need to take substantial risk. Today, low risk bonds and money market investments can produce 4%+ yields, which are levels not seen in more than a decade.

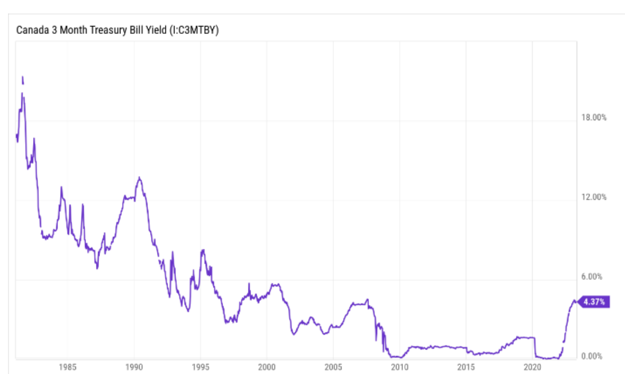
Growth: When interest rates are low, funding growth isn't expensive because capital (cash used for growing future profits) is abundant and cheap. When interest rates increase, that capital is more expensive and harder to obtain. Over the past decade many companies with uncertain business prospects and/or weak business models have borrowed cheaply to assist their organizations. Those firms now find themselves in a different and increasingly perilous situation given rising rates.

Sentiment: It's much easier to imagine a positive story when interest rates are low, and capital is readily available. Higher rates often expose narratives that lack fundamental substance. There is one category that tends to hold up well under higher rates; companies with high earnings who possess an economic moat or competitive advantage. These types of companies can thrive with higher interest rates, as they generally have less need for expensive capital than their weaker competition.

Investments that made perfect sense when interest rates were low may no longer be appropriate. Over the past year we have been making changes within our client portfolios to reflect this reality. Listed below is a sampling of investments which do well in a low interest rate environment and vice versa.

	Lower interest rates	Higher interest rates
Best investments	Real estate, high growth companies	Bonds, highly profitable companies
Worst investments	Cash, Bonds	Companies without a competitive advantage

Central banks around the world may be nearing the end of the rate hiking cycle, but that does not necessarily mean they will be cutting interest rates soon. From a historical perspective, current interest rates are still quite low (see chart right). Our demographics and employment trends make it unlikely we will return to the extreme interest rates experienced in the 1980's and 90's, but it is also unlikely we return to the zero-interest rate policy of the recent past. We will continue to make portfolio changes that will navigate current and future looking interest rate policy and look for the best risk/return options for your portfolio.



Your *looking forward to summer weather driving* portfolio manager,

Duncan Stewart, MBA, CIMA, FCSI, CFP, CPWA

duncan@stewartfinancial.ca / duncan.stewart@manulifesecurities.ca