Recalibration of Equity Risk Premiums

Central Banks have a difficult balancing act ahead of them.

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March 5, 2021

What February has shown us is that markets are becoming heavily dependent on fiscal stimulus and loose monetary conditions. Companies have become reliant on cheap financing to keep interest payments on their large amounts of debt sustainable, while high valuations are the result of using these low rates to calculate the intrinsic value of a stock. In the following article, we'll discuss the recent movement in U.S. Treasuries, the impact on equity valuations, and the effects these developments can have on your portfolio.

Why are we discussing U.S. Treasury Bills?

Before we dive into the mechanics of interest rates and their impact on equities, it's important to provide some background on U.S. Treasuries, colloquially referred to as T-Bills, the asset we'll be using for the basis of our discussion. The U.S. Treasury market is one of the most secure and liquid financial markets in the world. Governments, corporations, pension plans, in addition to a wide swath of financial market participants use U.S. Treasuries as a savings vehicle that pays a secure amount of interest and can be readily converted to cash if need be. These assets are backed by the U.S. Treasury (as you likely could have surmised from the name), meaning if the government was ever at risk of defaulting on an interest payment on one of these issuances, they could raise taxes to increase revenue and meet the interest obligation. Never in the 92 years of the U.S. government issuing these bills, have they defaulted on a payment and with the United States economy being the largest in the world, as measured by Gross Domestic Product (GDP), it's easy to understand why investors feel safe holding them.

Due to the inherently secure nature of these assets, investors commonly refer to them as 'risk-free' assets. By having this distinction, analysts can use the yields of these assets to represent a trade-off when calculating the value of a security. If an investor could receive x amount of interest guaranteed over a period, what would they need to earn from this riskier security to feel comfortable holding it instead of the risk-free asset? Analysts have constructed a formula to estimate the fair value of a stock using this trade-off, called the Discounted Cash Flow (DCF) model. This model, which we will discuss in greater detail below, typically uses the rates on U.S. Treasuries in its formula when calculating the value of U.S. equities.

With the understanding that yields on U.S. Treasuries can be used when valuing stocks, it is easier to understand why a rapid spike in U.S. Treasury yields would create a significant downdraft for equities. To give context, yields on U.S. 10-year Treasuries climbed 41% from the start of the month to a high of 1.54% on February 25th[1]. Yields on other global sovereign bonds replicated this appreciation before receding after central banks stepped in to purchase these assets. The act of purchasing these assets is called Yield Curve Control: when a central bank steps into the market and buys sufficient amounts of the assets to provide a floor to prices and limit the upward trajectory of yields, due to the inverse relationship between bond prices and yields. To elaborate, if a bond specifies it will pay a set amount of interest, and if the price of that bond goes up, the net return you will collect in interest payments until maturity falls.

How does inflation influence the price of these assets?

What could lead to a massive climb in U.S. Treasury yields? One scenario is that with positive economic data coming through in conjunction with improving COVID-19 infection rates, paired with continued support in the form of fiscal and monetary stimulus, inflation expectations have been rising. If inflation were to rise, the interest payments on these securities does not recalibrate higher, meaning your purchasing power is eroded making them less attractive to hold.

Central banks in developed countries usually share the stated mandate of maintaining inflation at an annualized rate of 2%. If inflation rises above this, you could face rapid deterioration of purchasing power for people's savings. With inflation below this, consumption slows as people expect they can purchase a good the following year at a cheaper price. This 2% target has come under scrutiny recently as being too strict of a mandate, and has led to central banks, like the U.S. Federal Reserve, to switch to an average inflation target of 2%. This means they would be comfortable with inflation rising above this target for a short period, if it averages out to 2% over a longer term.

One tool a central bank has at their disposal to combat 'runaway' inflation is to raise policy interest rates. When this happens, existing bonds lose value as the interest they are required to pay inherently provides less value, leading to investors selling the asset. When there is a rout in these markets and a glut of the securities being sold, this can put immense downward pressure on prices. Prior to the change in sentiment in February, using Treasury Inflation Protected Securities (TIPS) as a gauge, investors expected the U.S. Federal Reserve to begin raising their benchmark interest rate in 2024. This has now been pulled forward to 2022, signifying expectations for a more rapid economic recovery and higher inflation.

How is this impacting my portfolio?

So how does this come into play in the equity market? As we briefly discussed earlier, one method for calculating the intrinsic value of a stock is to use a DCF model. To recap, this model uses a risk-free return as a 'discount rate' in which yields on U.S. Treasuries can act as a proxy. The analyst then uses a formula to estimate the value of a series of future cash flows (i.e., a company's net earnings), discounting it to a present value using the previously mentioned rate. When this discount rate is low, future cash flow represents a greater value (think 10 divided by 1 versus 10 divided by 5). As this discount rate climbs, investors are presented with the option of swapping out a risky future cash flow for a guaranteed return on a risk-free asset.

We can use this model to compare future cash flows of different companies to derive an estimate of their intrinsic value and help provide a basis for investment. Where we see a dramatic difference is when comparing Growth companies to Value companies. Put simply, Growth companies are usually ones in their infancy, typically industry disruptors, who are quickly growing revenues while Value companies are ones that have reached maturity, maintain their market share, and grow revenues at a consistent, albeit lower, rate.

Without going into the fundamentals of the calculations, we'll massively oversimplify and look at the performance of two stocks over the last month as yields were rising. The first is Tesla (TSLA:US) which has 5-year expected annualized Free Cash Flow (FCF) growth of 53% and the other is 3M Co. (MMM:US) with expected annualized FCF growth of 6%[2]. During the month of February, Tesla shares dropped in value by 14.87% while 3M shares gained 0.48%[3]. Setting aside other valuation factors like industry trends, investor demand, news, and macroeconomic variables, this comparison demonstrates that a company with higher FCF growth will realize a greater benefit as discount rates fall and will inversely be disproportionately impacted by rising rates.

How can I adjust my portfolio to mitigate inflation risks?

Is this the beginning of a rotation from Growth to Value? We believe it's likely, but the shift won't be as sudden as some are expecting. While the recent climb in yields has been dramatic and the selloff in Growth companies disconcerting, we believe this is a temporary discomfort in many investors' portfolios. We believe we will see higher inflation in the future which will lead central banks to raise rates to keep it in check, but this is likely some ways away. Many countries are still coping with high unemployment from the pandemic (less money to spend on goods) and an aging demographic (higher savings rate), which are socioeconomic factors that inherently keep inflation low. In addition to these elements, we're also experiencing deflationary factors like high debt and mass adoption of technology designed to achieve lower input costs.

It's important to note that these securities could also be selling off due to improving confidence of institutional investors. As the U.S. forges ahead with their vaccination efforts, consumer and business confidence improves. With this improving confidence, investors will sell these assets to raise cash to finance operations, to reinvest into riskier assets, or to cover capital expenditures. What's notable is that there is still significant capacity in the economy, meaning there are plenty of goods and labour to be shared amongst participants. A fundamental function of inflation dictates an economy needs to be near full capacity for inflation to take hold, unless we were entering a period of stagflation where both inflation and unemployment are high, although this scenario is less likely.

There has been massive amounts of money pumped into financial systems, and the transmission method in developed markets like the U.S. has an exponential growth effect on this stimulus (à la Fractional-Reserve Banking), but this has also helped avoid longer lasting damage to businesses. As this money is deployed into the economy, we will see a rise in consumption that could lead to pockets of temporarily higher inflation, but this will be difficult to sustain.

Central banks seem to have learned from prior missteps. Rather than a rapid rise in rates or a sudden stop to stimulus efforts like Quantitative Easing, we will likely see a gradual tightening of monetary conditions. This allows investors to gradually adjust their portfolios to these overarching economic trends and mitigate sudden, drastic movements in their investments. We've experienced, even as recently as the 2018 'Taper Tantrum', what happens if central banks do not commit to a gradual unwinding of their balance sheets and a slow increase in interest rates. It's important to be aware of these changes and the pace that they're coming about, which is why we have been recommending clients begin trimming back on these Growth stocks and allocating more of their capital to Old Economy Value companies. These are changes we have begun to implement within our Managed Portfolio service starting in late January.

If you're concerned with the recent volatility in your portfolio, you may be ready to make some adjustments so that these risks and returns match your tolerance and objectives. Please feel free to contact our team if you'd like to review your investments or make any changes. We're always here to help.

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1 - U.S. department of the Treasury. (2021, March 05). Retrieved March 05, 2021, from https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield

2 - Future Estimates: Average up to 29 Analyst Estimates (S&P Global)

3 - SIA Charts - Performance. (2021). Retrieved March 05, 2021, from https://www2.siacharts.com/Charting/ChartingPost