"Interest rates are to asset prices as gravity is to the apple."

Warren Buffett, Berkshire Hathaway AGM, May 2013

With the US Federal Reserve beginning to tighten interest rates for the first time in nine years, clients have started to ask what the effect of a rising interest rate environment is likely to have on the share market.

By definition the value of any asset is partly determined by the prevailing interest rate. Interest rates represent the cost of money used to purchase an asset – either in the form of foregone income or loan repayments. If interest rates are low so too is the cost of money and asset prices are bid up by the market. If they rise money becomes more expensive and asset prices tend to drift lower.

The mistake investors often make is to project the current interest rate out over the period that they will hold the asset, and base their valuation of the asset on that rate. This can lead to some serious mis-pricing. The RBA's cash rate has been between 2% and 17.5% over the past 26 years and has averaged 5.58% over that period. It currently sits at 2%. To assume that it will stay at this level forever is clearly foolhardy. A 10-year government bond (where the only variables are the interest rate and the government's ability to repay the bond) currently worth $100 would be worth just $72 if the RBA cash rate returned to its long-term average and $27 if it reached its 1990 levels. This effect would touch most asset classes, including residential property and equities.

If we compound this effect by considering that many people have borrowed to the hilt at record low interest rates to buy residential property and that many self managed super funds, frustrated with low term deposit returns, have bid up the price of shares in relatively good yielding securities such as the banks and Telstra, and then throw in a bit of "madness of the crowds" when the tide turns, the effect of rising interest rates on the prices of some of these assets could be quite disruptive.

The good news in the event of this scenario playing out is that it would provide opportunities for investors prepared to look through the cycle and focus on the fundamental qualities of individual securities.

December 2015