graviton

member of Sanlam group

# What's in store for interest rates?

**After two years of global interest rates hovering at record lows, the accommodative environment that central bankers and governments created to support their economies during the worst health crisis in a hundred years is coming to an end. Interest rates have a broad impact on valuation levels across asset classes and currencies. These accommodative policies have therefore played a significant role in the strong market environment that we've experienced over the last 18 months.**

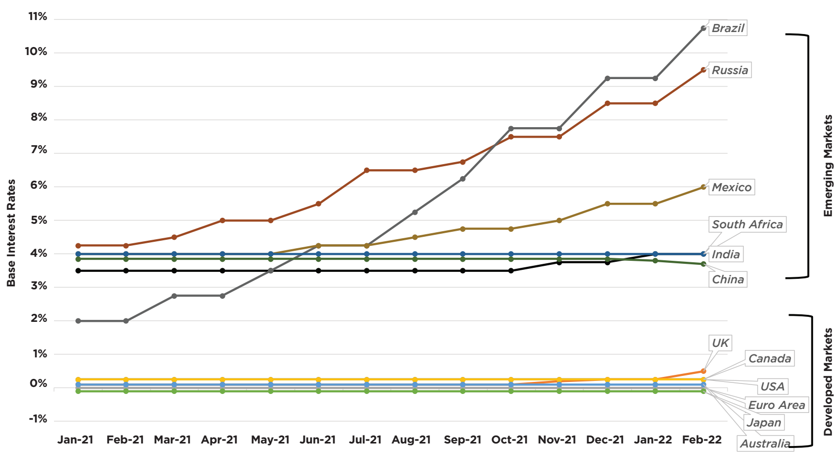
**The question now is what to expect from markets in an era of more aggressive monetary policy.**

**This is the first article in a two-part series on the current rising interest rate environment, to provide some context on the path of interest rates, how we arrived here and where we are headed. The second article focuses on the impact of rising rates on asset classes and the funds used in your portfolios.**

## What are we seeing at the moment?

Most countries in the world are in some stage of monetary tightening, which means that central bankers are becoming less accommodative by either withdrawing support for the bond markets or by raising interest rates. The drivers of interest rate policy differ from country to country and as a result, countries are at different stages of tightening. Emerging markets are relatively far down the road of raising interest rates, while developed markets are only getting started. South Africa had a unique combination of circumstances that allowed us to defer raising rates sooner, with the result that we are relatively far behind other emerging markets. China is the only major economy that is moving in the opposite direction, where they have started cutting rates again to support their ailing property sector.

**Chart 1: Interest rate increases over the last year, for select countries**




Source: Trading Economics, Sanlam Investments: Multi-Manager

The previous chart shows the different interest rate trajectories in the largest developed and emerging markets around the world over the last year. Among emerging markets, Brazil was the most aggressive, with their base interest rate increasing by 8.75% from 2% to 10.75%. Russia raised rates by 5.25% for the year, however subsequent to the invasion of Ukraine, Russia's central bank raised its key interest rate from 9.5% to 20% on the 28th of February.  This significant hike is designed to shore up the ruble as Western countries expand sanctions on Moscow for its invasion of Ukraine.

The situation in the Eurozone will have to be monitored in the next few weeks as the impact and consequences of the unrest in the area continues to be uncertain. South Africa increased rates by a more muted 0.5% since November, while Mexico increased rates by 2%. India remains unchanged at 4%, while China cut rates by a cumulative 0.15%. In developed markets, the UK increased their base rate by 0.4%, from 0.1% to 0.5%. The US is still at 0.25%, while rates in the European Union and Japan have not been adjusted since 2016, when they were cut to 0% and -0.1% respectively.

## Why are interest rates rising?

Countries are not necessarily raising interest rates for the same reasons. The trajectory of interest rates depends on underlying fundamental factors like inflation, employment and economic growth, and also on the mandates of central banks. For example, the US Federal Reserve (the Fed) has a dual mandate to maintain stable prices and to promote maximum employment, while the South African Reserve Bank (SARB) has a single mandate to maintain stableprices. Consequently, the SARB started raising interest rates earlier than the Fed despite our more moderate inflation environment.

There are three primary factors influencing the current round of monetary tightening around the world: persistently high inflation, policy normalisation, and currency protection.

### 1. Persistently high inflation

Inflation is a problem in most countries around the world at the moment, but especially in the US and Europe. The most recent inflation figure in the US came in at 7.5%, while the UK and EU came in at 5.4% and 5.2% respectively. All well above their central banks' target of 2%. The last time inflation was this high in the developed world was 40 years ago during the oil crisis in the 1970s.

The surge in inflation was initially written off as temporary in nature, caused by disruption to the global supply chain during the Covid-19 lockdowns. Supply chain disruptions continue to be a significant cause of high inflation and have been more persistent than expected. However, other factors have also started to contribute to the higher inflation numbers. This includes higher consumer demand caused by unprecedented government stimulus; Americans not returning to work, creating upward pressure on wages; low mortgage rates and strong activity levels during lockdown resulting in a jump in housing prices; and oil and natural gas prices kept high by reopening economies and political tensions in the Middle East and Eastern Europe.

**Table 1: Inflation levels and causes, for select countries**

| Country | Current inflation | Avg Inflation Target | Multiple of Target | Reason for high inflation | Inflation concerns |
|---|---|---|---|---|---|
| USA | 7.50% | 2.0% | 3.8 | Supply chain disruption, wage pressure, housing prices | High |
| UK | 5.50% | 2.0% | 2.8 | Supply chain disruption, energy prices, labour shortages following Brexit | High |
| Euro Area | 5.10% | 2.0% | 2.6 | Supply chain disruption, energy prices due to Russia/Ukraine issues | High |
| Japan | 0.50% | 2.0% | 0.3 | Low inflation | Low |
| South Africa | 5.70% | 4.5% | 1.3 | Supply chain disruption, energy costs, food prices | Moderate |

Table 1 above shows the unusually high inflation in places like the US and Europe, which has made the temporary inflation argument less convincing, and put significant pressure on central bankers in those regions to act. The SARB, by comparison, is not under the same pressure to raise interest rates in response to inflation, considering it is still within its 3-6% target band.

There is a lot of debate around whether higher rates will be able to curb inflation, considering that exogenous factors like supply chain disruptions and energy prices are largely outside of the control of central banks. Nonetheless, inflation concerns remain a significant contributor to higher interest rates at the moment.

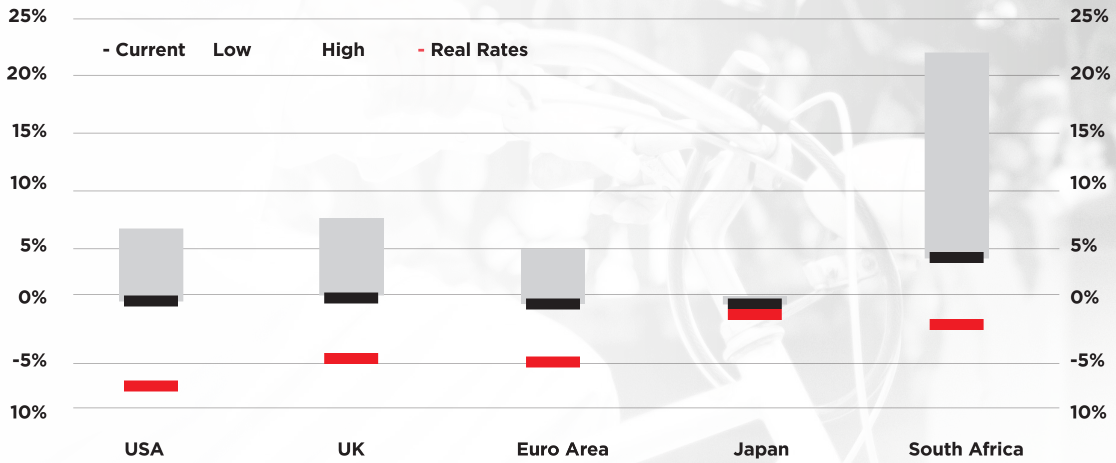
## 2. Policy normalisation

Markets have become nervous about any talk of higher interest rates. We saw this in January when global equities corrected by more than 10% on the back of a more aggressive Fed. However, what is often forgotten is that the current level of interest rates is not normal but was introduced to support economies reeling from an unprecedented health crisis. Even in the absence of high inflation, interest rates were going to have to go up at some point or another.

This can be demonstrated in Chart 2 below, which shows the range of interest rates in a select group of countries over the last 25 years (grey bars), the current nominal rates (in black) and the inflation-adjusted/real rates (in red). Nominal interest rates remain close to or at the lowest point in their 25-year ranges across the sample. Similarly, taking inflation into account, real rates are in deep negative territory, which means that investors effectively lose money in real terms when they invest in cash.

Neither of these two scenarios are sustainable over the long term. Therefore, the logical outcome is to pave the way for policy normalisation as central bank targets are met. In the US, for example, unemployment is largely back to pre-COVID levels, which means that the Fed's mandate to promote maximum employment is largely met.  This supports higher interest rates even in the absence of high inflation.

**Chart 2: Historical interest rate range relative to current nominal and real rates (include source)**



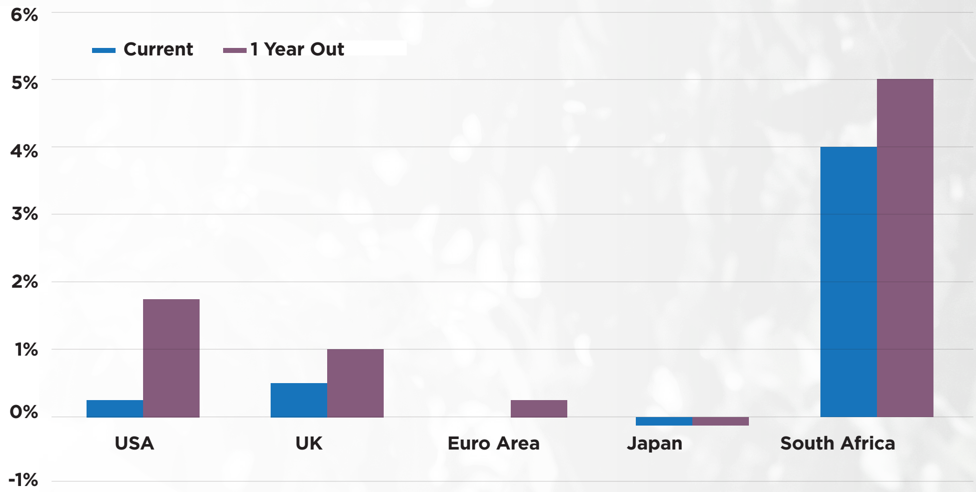

## 3. Currency protection

Countries compete for international capital by offering compelling risk-adjusted returns. For example, if the US starts raising interest rates, it creates demand for US dollars because it becomes more compelling for investors to invest there than before. If a country does not participate in the rate hiking cycle, it runs the risk of a weakening currency. This is especially true for emerging economies like South Africa. The concern is that a weaker currency will cause higher inflation through higher imports costs, especially oil. Import inflation is a major concern of the SARB, and hence they use interest rates as a tool to support the currency during this environment.

## Where to from here?

Chart 3 below shows the current expected trajectory of interest rates across major regions and South Africa over the next year. Surging inflation has caused interest rate expectations in the US to change significantly from a few months ago. While the market was not pricing in any interest rate increases in 2022, it is now expecting at least six rate hikes of 0.25% this year, with more to follow in 2023. This rapid change in outlook caught the market by surprise and was largely responsible for the pull-back we saw in global markets in January.

**Chart 3: Expected trajectory of interest rates over next year**




Source: Sanlam Investments Multi-Manager

Locally, the expected path of interest rates seems much more certain compared to the US, given the more contained domestic inflation outlook. Nevertheless, to keep inflation in check, normalise policy and to support the rand during this time, we expect a gradual increase in the repo rate by 0.25% per quarter, or about 1% per year for the next two years.

South Africa is by no means the only country raising interest rates. The SARB's outlook is actually quite benign and our expected path of interest rates more gradual when compared to other emerging markets and even the US. Local inflationary concerns are also relatively more muted, with the biggest risk coming from a weaker rand, rather than runaway local inflation.

However, considering we are entering a relatively broad-based monetary policy tightening environment, we have to be cognisant of the impact of rate hikes on asset classes, especially if we see more hikes than what is currently expected. This will be covered in more detail in part 2 of the series.