The Effect of Interest Rates on Market Valuation

By Chase Hinderstein, Vice President and Portfolio Manager

It seems at times that market watchers are consumed by future interest rate forecasts. This is despite the fact that one of the first lessons in economics is don't bet on the direction of interest rates. Both stocks and bonds have risen together for years from rates staying at yields so low they have little historical comparison. Recently, interest rate moves are one of the top financial stories on any given day. This isn't just about the impact that low rates have on the economy. Interest rates and the central bank's ability to move them have a direct impact on how much home you can afford, how cheap a car loan you can get and, of course, how cheaply a company may borrow cash. Beyond these economic effects, interest rates have a more immediate impact on the value of the stock market.

Whether you're evaluating the S&P 500, shares of Apple or your local utility stock, the basic formula for stock investing is often a variation on three factors. The equation involves an estimate of what that asset will earn at some point in the future and a forecast for a future dividend, an interest rate to discount what those future earnings are worth to you today and a resulting multiple which that stock will command as a result of the first elements. For example, compared to historical averages, the S&P 500 is trading at a premium price multiple to next year's earnings estimates. At the same time, the expected growth rate of earnings for the S&P 500 and/or the economy is quite modest, especially compared with the rate of earnings growth at other times the market has reached such lofty multiples. Surely any investor would be inclined to pay a richer premium (P/E) if they believed in higher earnings next year or accelerating growth as time moves on. But how is it that today we can reach these levels without the compelling growth?

The answer is that a dollar earned next year, or five years from now, is worth more to me today than at almost any time in history. I would be applying such a low interest rate while discounting that future dollar back to today. A dollar of earnings next year is worth almost a dollar to me today. However, if the rate at which I discount those future earnings is increased, then maybe next year's dollar of earnings is only worth $0.95 to me today. If that were the case, I wouldn't be willing to pay the same premiums.

The first half of 2015 has been an especially volatile period for the stock market, but without having any true correction or much forward progress in price. We've been bouncing around at a level that's equal to about 17-18x next year's earnings guess for the S&P 500. This is certainly elevated and near some historic peaks. It's because those future earnings are not discounted at all to today's value that we can maintain an expensive market while not growing earnings very much. Now consider if your expectations to earn a dollar in 2016 would instead improve such that you anticipated $1.25 in earnings. If the other factors remained equal, then the markets would take that asset to a higher valuation level. Accelerating earnings growth can overcome rising rates depending on their scale. Some inflation, which corresponds with gently rising rates and rising earnings, have typically commanded the highest earnings multiples for the stock market. This is why it's essential that the expected rate of earnings growth accelerates ahead of, or at the very least along with, an increase in interest rates. If that happens, then the markets or specific stocks can maintain their multiples and trade higher.

This is the daily battle of the markets in 2016. It's not only that higher rates may affect the economy or earnings, but they will also make those future earnings less valuable today. If the estimates for the earnings themselves are increased, then the valuations can continue to increase, even with higher interest rates. With dramatic bits of news serving as daily distractions, it's ultimately about the tug of war between expected earnings growth and expected interest rates. If factors sway beliefs towards higher rates without accelerating earnings growth, then we'll see a slip in price. If global economic malaise steers us to believe in the continuation of the nil yield era, then modest earnings growth, absent inflation, can continue to be the recipe for higher stock prices. The worst scenario leads to higher rates (inflation) without tangible economic growth (earnings acceleration). That would ultimately send the market's multiple to earnings lower (correction). Since we cannot make much more than an educated guess to the direction and timing of interest rate moves, we must reflect on the premiums priced into our holdings or in the prices of the companies we consider purchasing. The variability of outcomes is far greater if estimates are based on some guess of what a developing company hopes to achieve five years into the future over the course of an economic cycle.

The earnings estimate can be made with strong confidence if it doesn't forecast much more than a year forward for a company with a long-established history of delivering results. The company's own history of delivering on expectations and resilience in varying economies can build more confidence and deserve higher premiums at times like these. However, as we've learned through other premium market cycles, it's necessary to reflect on normalized multiples to these future earnings and consider the amount of risk being carried in the form of premium stock prices.

The businesses themselves may continue to be well run and deliver on expectations. But, if a portfolio is carrying too much risk in the form of premiums in prices, then a simple multiple contraction can quickly erase a chunk of corpus without the companies missing a beat. If value is ignored in favor of momentum at times of modest growth and the potential for rising rates, then ultimately the portfolio is subject to extraordinary downside risk. If the holdings are of quality and the multiples are monitored, then the volatility of price action will have less of a lasting long-term effect.

The S&P 500 Index is an unmanaged, market capitalization weighted index of 500 common stocks widely regarded to be representative of the US market in general. Indices are unmanaged and direct investment is not possible. Past performance is no guarantee of future results. All investments carry some level of risk including loss of principal. The opinions expressed are those of the author and not necessarily those of Robert W. Baird & Co.

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