Prescient
INVESTMENT MANAGEMENT

Interest Rates: Tracing the domino effect on economic stability

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The intricate interplay of various factors often dictates the trajectory of growth and stability within a nation's financial landscape. One such critical determinant is the interest rate set by the central bank, which can significantly influence a nation's economic direction.

As a starting point, when central banks increase interest rates, it's typically done to “cool down” an overheating economy or combat inflation. Elevated interest rates mean that the cost of borrowing increases for both businesses and consumers, which is then expected to make borrowing less attractive. This may lead to a reduction in spending and investment, which in theory is expected to curb inflationary pressures. Significantly, however, the impact of these rate hikes can extend beyond curbing inflation and potentially result in an economic slowdown.

First and foremost, higher interest rates lead to increased borrowing costs for businesses and individuals. For businesses, this means higher expenses for financing their operations and capital investments. Small and medium-sized enterprises (SMEs) tend to rely heavily on credit to fund their growth. When interest rates surge, these businesses face challenges in servicing their debt, which, we have seen, hampers expansion plans and also reduces business activities.

Additionally, elevated interest rates are associated with higher target returns for potential investments, given that with increased cost of borrowing, investors often seek higher returns on investments. This in turn renders fewer projects economically viable. Consequently, a diminished number of viable projects leads to a reduction in overall investment activity, amplifying the economic impact of higher interest rates.

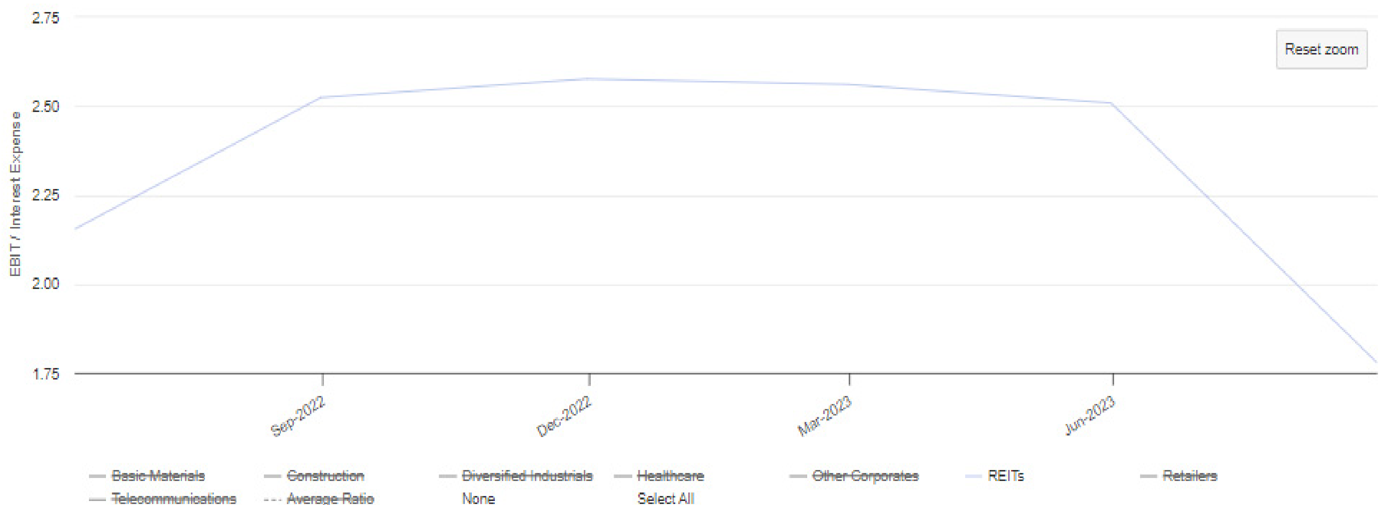
Consumer behaviour is also heavily impacted by higher rates, especially those who have variable-rate loans (think prime-linked home loans, store credit or credit card debt) because they experience increased debt servicing costs that thus less disposable income. Consumer spending, a significant driver of economic activity (and growth), tends to decrease when interest rates rise, contributing to an economic slowdown.

High interest rates undermine the profitability of Real Estate Investment Trusts

As a simple example in the corporate sector, let’s consider the **Real Estate Investment Trust (REIT)** sector and how interest rates impact their credit worthiness. As a starting point, REITs often face challenges during prolonged periods of higher interest rates due to their sensitivity to borrowing costs. REITs rely heavily on debt financing as their funding source, and when interest rates rise or remain elevated for prolonged period, despite hedging activities, the cost of servicing that debt increases. This higher interest expense can erode the profitability of REITs, as it directly affects their net income.

To show this graphically, one of the corporate health variables we employ in our process is the relationship between interest and profitability, via the Interest Coverage Ratio.

Figure 1: REIT Interest Coverage Ratio



Source: Prescient Investment Management, Bloomberg (as at 30 September 2023)

When considering figure 1, with the understanding that gearing activities within the sector have remained relatively benign compared to the pre-COVID era and taking REIT activity measures into account, one is able to understand that a worsening Interest Cover Ratio reflects REITs' diminishing ability to meet their repayment obligations, and as such would be one factor of many that raises the risk of default.

Additionally, rising interest rates may make alternative investments, such as bonds, more attractive to investors seeking higher yields with lower risk. As a result, the relative appeal of REITs, which typically distribute a significant portion of their income to shareholders, may decrease in comparison to fixed-income investments. Consequently, during periods of higher interest rates, REITs may experience a decline in share prices as investors reassess their portfolios in search of more favourable risk-adjusted returns.

For debt investors applying quantitative methodologies, share price volatility is a crucial component in the default assessment process. Simply put, higher volatility implies a greater range of potential future outcomes, which increases the probability that the firm's market-implied asset value may fall below the value of outstanding debt. With regards to the assumption of a reduction in a company's market capitalisation (i.e., the share price falls), market uncertainty and volatility often rise, amplifying the potential for default within this framework.

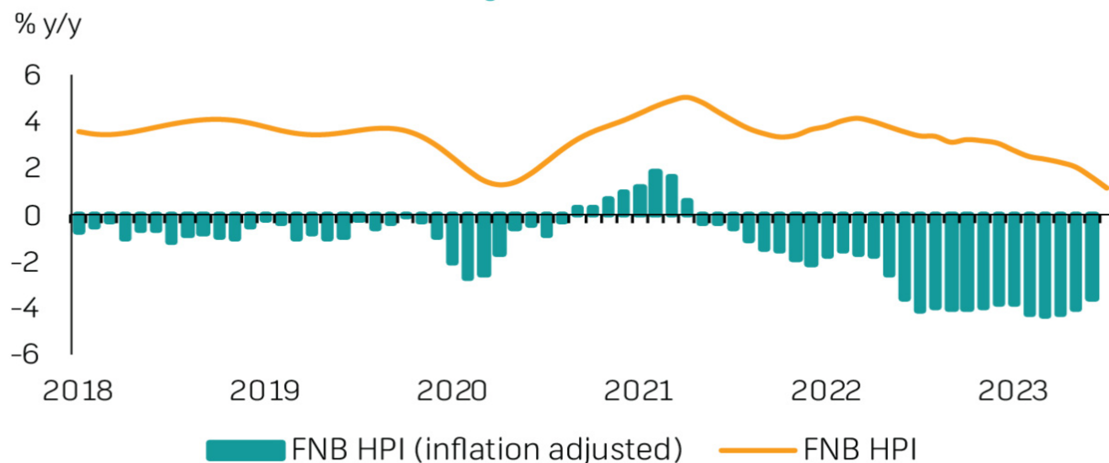
Ripple effect of higher interest rates on the broader real estate sector

The impact of higher interest rates extends beyond the direct implications for REITs to encompass the broader real estate sector, a pivotal component of most economies. The real estate market is intricately linked to interest rates, with an evident ripple effect. As interest rates rise, so do mortgage rates, rendering homeownership less affordable for prospective buyers.

This diminished affordability can trigger a reduction in demand for housing, culminating in a slowdown in construction activities and a subsequent decline in real estate prices.

This is a clear case in point in South Africa where the housing market remains sluggish, as evidenced by the continued decline in the FNB House Price Index, as highlighted in figure 2 below:

Figure 2: FNB House Price Index (as at October 2023):



Source: FNB Ecomonics

A real estate market that is under pressure not only affects property developers but also reverberates through interconnected industries, such as construction, home improvement, and furnishings.

An additional aspect to consider is the psychological effect of rising interest rates. Investor and consumer confidence often hinge on the perception of economic stability and growth. Periods of heightened interest rates often tend to instil a sense of caution and uncertainty about the future for investors and consumers, resulting in reduced investment (and spending), creating the self-fulfilling prophecy of an economic slowdown.

While central banks may employ interest rate hikes as a tool to control inflation and ensure a sustainable economic path in the long term, the short- to medium-term consequences of these actions are serious. The potential onset of an economic slowdown, triggered by rising interest rates, underscores the delicate balance that policymakers must maintain, especially in times where rates are used as a means to curb supply-driven inflation as opposed to demand-driven factors.

Negative impacts of higher interest rates – summary:

1. Higher debt servicing costs
2. Negative impact on vulnerable sectors
3. Less capital investment
4. Economic slowdown

In examining the impact of higher interest rates on the economy, it’s evident that the intricate interplay of these challenges poses a significant threat to borrowers across diverse industries, hampering their ability to meet debt obligations amid a broader economic slowdown fuelled by rising interest rates. As we navigate this complex landscape, it becomes crucial for stakeholders, from policymakers to businesses, to develop strategic responses that safeguard economic resilience in the face of these evolving interest rate dynamics.

About the author

Conway joined Prescient in February 2021 as Head of Credit. As the custodian of the Prescient credit process, and Portfolio Manager across the credit offerings, his responsibilities include continuously refining, implementing and managing its philosophy and process, with a focus on delivering on portfolio return objectives. He is also responsible for determining the long-term strategic objectives of the Credit team, building skills and synergies in conjunction with the other senior members of the investment team.

Conway has worked in the industry since 2009 and previously held positions at Old Mutual SA (2007-2009); OMIG Central Research (2009-2012) and Futuregrowth Asset Management (2011-2020) – where he was the Joint Head: Unlisted Credit.

He holds a BBusSc (Hons) and CTA, both from the University of Cape Town, is a qualified Chartered Accountant and completed a Masters in Philosophy (Development Finance) at University of Stellenbosch Business School (USB). He also holds the CDFA designation, as well as directorships at various companies, which is supported by his accreditation achieved through the African Director's Programme (University of Stellenbosch). Conway also holds an eMBA (Valar Institute).

Outside of work, his interests and hobbies include reading, sports (rugby, cricket and football), hiking, community involvement and 4x4-ing.

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PIM specialises in portfolio and risk management, managing money on behalf of retirement funds, medical aid schemes, corporate entities, trusts, and individuals. Its investment solutions range from unit trusts and retirement fund portfolios invested in all the listed asset classes through to infrastructure and clean energy debt funds.

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