Lynx
Investment Advisory

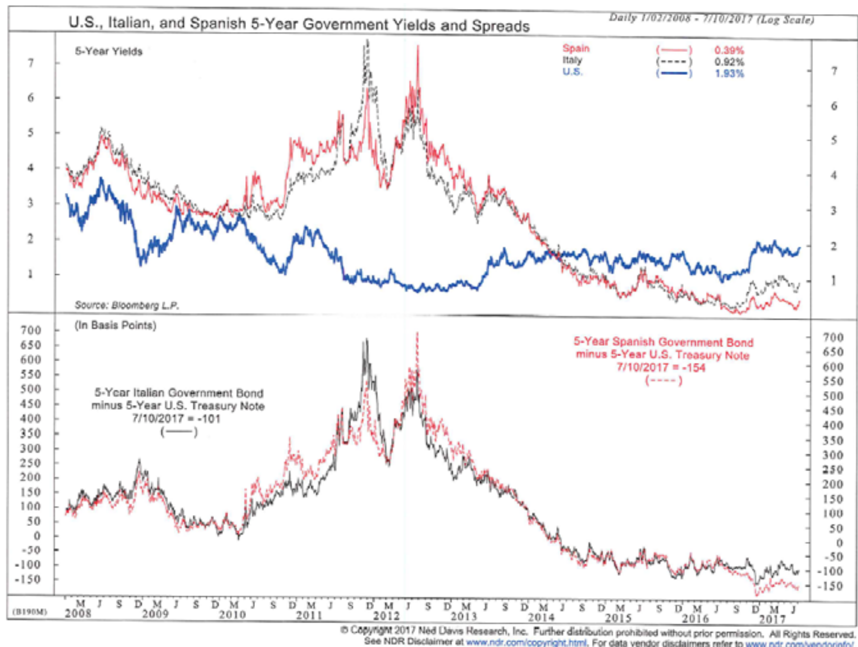
## Rising Rates: Three Recommendations for Investors

Over the last few weeks central banks across the developed world have begun to prepare the capital markets for a rising rate environment by signaling an end to easy money policies. The initial market reaction to these signals has been swift and rates across the globe have risen (see chart 1). Given the possibility of a new trend in rates, this paper will focus on asset classes that an investor may choose to underweight or enhance during these times.

Chart 1:

At Lynx we believe that moving to a more normal interest rate environment is very healthy for the long-term growth of the market. Low rates driven by extremely accommodative monetary policies have distorted the fundamentals of the market to an extent that lower rated credits, at times, yield less than higher quality credits (see chart 2). Italy and Spain, two countries that nearly defaulted on their debt, trade at lower yields than United States debt. Anomalies such as these have distorted fundamentals and mispriced risks.

Chart 2:




That said central banks will need to tread carefully; global debt is a higher proportion of world GDP than it has ever been and the markets have not reacted well to past announcements of stimulus tapering such as what was experienced during the original taper in 2013 (see chart 3). Moreover, central banks need to make sure they don't dampen global demand in the process.

Chart 3:

Therefore, the question is, in this environment, what should investors do? We have three recommendations, driven not only by rising rates, but also by the fundamentals of the sectors.

- **Stay away or lighten-up on weaker credits:** It's a misconception that the rising rate environment only impacts interest sensitive assets. While Treasury securities only have interest rate risk (i.e. no credit risk) and thus are seemingly more sensitive to interest rates, cheap money policies encourage investments with high credit risk (in the hunt for yield), securities that might not have been funded in a more normal rate environment. As rates rise, the higher cost of refinancing such projects often leads to higher defaults, as was the case when the housing bubble burst in 2007. The current spread for junk securities is currently very tight, therefore, an investor is not leaving much on the table (lost opportunity) when moving away from such credits.
- **Be careful of emerging market currencies (not countries)**: As rates rise in the developed world, emerging market currencies tend to sell off. This is a direct result of a rising U.S. dollar (or another developed country currency) and the ensuing fear that the emerging market countries will face higher borrowing costs in USD. While we believe the fundamentals of many emerging countries are on solid ground, more so than ever before, and find their equity valuations attractive, we advise caution when it comes to local currency bonds and external debt with questionable hard currency reserves.
- **Financial stocks may do well:** Historically, a rising rate environment accompanied by a stronger economy and steepening yield curve has been especially favorable for financial firms, particularly for those following a more traditional banking model of borrowing short and lending long. Given the recent signals by central banks, we believe this is the most likely scenario today; demand is accelerating while the Fed is moving to raise rates. Given the attractive valuations in the financial sector, we believe the stars are aligned for a recovery in these stocks.

In summary, we agree with the policy makers' approach of gradually raising rates and weaning the market off expansionary monetary policies, but we would like to caution investors to make appropriate amendments to their allocation at the same time. In addition, holding some extra cash during these times might be prudent, while cash serves to reduce duration of the portfolio, it also provides "dry powder" that can be used to take advantage of interesting opportunities not yet evident.