

INTEREST RATES CHANGE....WHICH CHANGES EVERYTHING

Interest rates are one of the most important variables influencing the value of financial assets. When interest rates rise, the effects are felt across virtually every asset class, including stocks, bonds, real estate, private equity, and infrastructure investments. Because valuations are fundamentally based on the present value of expected future cash flows, changes in interest rates can significantly alter investor perceptions of value. Rising rates not only reduce valuations but also increase uncertainty regarding future earnings, financing costs, and economic growth, creating heightened market volatility. Understanding the relationship between interest rates, valuation, and volatility is especially important during periods of monetary tightening, such as the Federal Reserve's rate increases in 2022-2023, or historical periods like the early 1980s inflation fight, the telecom buildout of the late 1990s, and the housing boom preceding the Global Financial Crisis.

How Rising Rates Impact Valuation

The most direct way interest rates affect valuation is through the discount rate used in discounted cash flow (DCF) analysis. In its simplest form, an asset's value equals the present value of its future cash flows:

$$\text{Value} = \text{Future Cash Flows} \div (1 + \text{Discount Rate})^t$$

When interest rates rise, the discount rate increases. As a result, future cash flows become less valuable in today's dollars, causing valuations to decline.

For example, consider a business expected to generate \$1 million of annual cash flow indefinitely. If the risk-free interest rate is 5.0% (and many will use the 30-year treasury yield as the discount rate) the business may be worth \$20 million (\$1m / 5%). If the risk-free rate was 10%, the same business will be valued at \$10 million or 50% less.

Nothing changed operationally but the doubling of the risk-free rate, which represents the hurdle rate for opportunity, completely changed the rational valuation.



"OH, LOOK - INTEREST RATES!"

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Every trading day, financial markets are “re-pricing” interest rates via changes in treasury yields or corporate bonds yields or the interest rate of a new debt issuance. But the majority of daily change is caused by short-term news and events from newly released economic data, inflation reports, central bank chatter and other news. The daily prices fluctuate far more than the change in long-term underlying economics.

Rising rates increases uncertainty in many things including economic growth. And this may impact changes in money supply, liquidity and confidence about future prospects. And changes in confidence may lead to larger reactions to economic news and events which translates into more volatile in prices.

Rising rates will impact asset classes differently. A long-dated fixed bond will likely fluctuate significantly but a business priced cheaply with stable earnings may fluctuate less. Duration is the key to any asset regarding price impact to rate changes. A short-term bond will reprice quickly whereas a money-losing growth stock with no cashflow has far higher embedded duration than a long-dated fixed bond. It all depends on the underlying asset and the ability to maintain and/or grow its cashflow.

The following summarizes 8 key lessons on how declining interest rates are fun whereas rising rates often brings challenges.

1. Low rates stimulate the economy.....higher rates restrict the economy
2. Low rates lift asset values and prices.....higher rates lowers values and prices
3. Low rates encourages more leverage.....higher rates discourages more leverage
4. Low rates generally aided by increased money supply.....higher rates restrict money supply
5. Low rates generally aided by increased liquidity.....higher rates generally restrict liquidity
6. Low rates contribute to the fragility of markets.....higher rates exposes the fragility built up
7. Low rates often creates asset/liability mismatch.....higher rates reverses the mismatch
8. Low rates may provide false confidence about the future.....higher rates exposes lack of confidence
9. Low rates subsidizes the borrower.....higher rates compensates the saver and lender

Interest rates continuously change, sometimes dramatically, but understanding the general tendencies help prepare for inevitable.