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RISING YIELDS IN THE US

August 2021

DEAR VALUED ADVISER,

We thought it prudent to update you on what we are doing in our portfolios now that US bond yields have started to rise.

Since the pandemic-induced sell off in March 2020, global equity markets posted a steady recovery. When the vaccine rollout gained momentum in November, those countries, commodities and companies who benefited the most from the reopening of the global economy performed exceptionally well.

Looking back, a synchronised monetary response by central banks around the world, who unleashed massive amounts of stimulus, stopped the rout in global markets.

But printing all that money has consequences...

The bond market is telling us that one of those consequences is future inflation. The US 10-year interest rate yield, the *de facto* risk-free rate of the global economy of which all other asset classes are priced, has risen by 54 basis points to close at 1.46% on the last Friday of February.

Source: EFPC, Factset

REMEMBER THOSE HOT IPOS PUNTED ON REDDIT AND TRADED ON ROBINHOOD?

Well, many of those companies earned little to no cashflow at present, which means that the bulk of their valuations are derived by attempts to calculate their terminal value - how much they would be worth in say ten years' time, and then bringing those values back to the present. Therein lies the problem, if the risk-free rate goes up, even a little bit, let us say 54 basis points, those company valuations come under considerable pressure. The discounted cashflow models used to value these high growth companies dictate that when risk-free rates go up, either terminal growth rates will have to follow suit, or market prices will have to come down. It is normally the latter that emerges victoriously, at least in the short-term. Equity valuations must also contend with a higher discount rate in order to get to a present value. The effect here is similar, when discount rates go up, share prices go down.

IS IT ALL BAD?

We do not think so, in fact, when yields rise for "good reasons" like an economic recovery, its typically good for most risk assets. We are not in a scenario like the taper tantrum of 2013, or even the mini tantrum of 2018, where markets expected the Fed to hike rates. In fact, the opposite is happening, Fed Chair Jerome Powell made it very clear that the Federal Reserve will remain accommodative and continue its current pace of balance sheet expansion.

Most believe that the Fed will only start hiking rates in the second half of 2024.

Furthermore, goods markets appear to have recovered from many of the supply chain disruptions they had to contend with deep in the pandemic. The purchase of stuff also quickly moved online. We expect this implies that a large portion of pent-up demand is for services, and supply of services can expand much faster than goods, lessening inflationary pressures. Pent-up demand also works differently for services; the fact that you haven't cut your hair in the past year doesn't mean you that you are going to cut it three times on the same day just because the pandemic is over.

A bit of inflation also drives revenue growth, and we expect that companies who dramatically reigned in costs during the recession will not simply move back to their old, frivolous spending habits as soon as the pandemic is over. This is good news for longer-term margins.

For now, rising real yields are playing a larger role than inflation in the overall yield expansion, something one would expect. Moreover, the joint rise of both inflation expectations and real yields implies a sustained expected recovery.

WHAT TO WATCH OUT FOR:

It will cause concern if real yields continue to rise while inflation expectations start to decline. This would signal that the market has stopped believing the Fed and expect short-term interest rates to rise.

WHAT TO DO:

We continue to tilt our portfolios toward opportunities that benefit from a world reopening, continued monetary and fiscal support, and where relative valuations are not excessive, especially when we factor in earnings growth driven by secular trends, and not just monetary support.

While we expect volatility to remain, we continue to construct client portfolios of what we believe are the world's best companies, while remaining diligent in the prices we are willing to pay.

In short, we will continue to closely monitor and adjust to these and other trends, in order to preserve and grow the wealth of our clients. As always, should you or any of your clients wish to discuss this or any other matter with us, please let us know.

Kind regards,

Riaan Prinsloo, CFA
Chief Investment Officer

81 Dely Road, Hazelwood, Pretoria, 0081 +27 (0)12 667 3771 admin@efpc.co.za www.efpc.co.za

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