

Revisiting a low growth, low interest rate, low inflation world through COVID-19

Part 3 - The relationship between growth, inflation, interest rates and valuations

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In this white paper series, we examine whether inflation is likely to stay at low levels over the next decade. We also examine how future inflation and overall economic growth rates will impact the attractiveness of the returns Hyperion's global equity strategy is likely to produce in the long run. The main topics covered in this series are addressed in five interrelated papers:

Part 1 - Why the recent increase in inflation and growth is temporary;

Part 2 - Why the rotation to lower quality value stocks will not be sustained;

Part 3 - The relationship between growth, inflation, interest rates and valuations;

Part 4 - Why high-quality businesses can handle high inflation better than most other investments, and;

Part 5 - What if our views on inflation turn out to be wrong?

Part 3 - The relationship between real growth, inflation, interest rates and valuations

Real rates of economic growth, inflation, interest rates and valuations are all interrelated.

Long-term government bond yields are largely determined by expectations for economic growth and stability (opportunity costs and associated economic risk) and inflation (reduction in the purchasing power of money). The return from long-dated government bonds represents the rate of return relating to overall economic growth in nominal terms. In other words, there are two key components of a government bond yield: 1) an opportunity cost component that relates to expected economic growth and stability levels that theoretically everyone can enjoy and benefit from, and 2) an inflation compensation component.

Long-dated government bond yields have increased over the past year as the economic outlook has improved and inflation expectations have increased. Recently, the 10-year U.S. government bond yield has risen sharply and is now approximately 136bps, compared to a low of 50bps last year. It is worth noting that this yield is still considerably lower than the average since the GFC of approximately 230bps.

Given the poor outlook for economic demand growth and the technology-based disruption the world faces, we continue to believe that any pickup in inflation over the next year is temporary and unlikely to be sustained over the long term.

High levels of inflation increase uncertainty for both consumers and businesses. High inflation is particularly damaging for holders of long-term bonds. This is because the return of the bond is set in nominal terms at the time of purchase, and a sustained increase in inflation will result in the real (inflation-adjusted) returns declining.

Equity holders are generally in a better position, because businesses have some potential to lift the prices they charge customers to help protect the real value of their future revenue and free cash flows. However, there will be many businesses that cannot pass on the cost of inflation and maintain their revenues and free cash flows in real terms. These stocks are likely to suffer materially from any sustained return to high inflation.

We continue to believe that inflation will remain lower for longer, **with our base assumption of 10-year U.S. bond yields to average 250bps over the next 10 years.**

Figure 1: U.S. 10-Year Treasury constant maturity rate over time



Source: Federal Reserve Bank of St Louis (2021) 10-Year Treasury Constant Maturity Rate in Percent (Not Seasonally Adjusted)

Discount rates are used to reduce estimated future cash flows to today's value. The higher the discount rate, the lower the current value of any set of future cash flows. The further out the cash flows are into the future, the larger the impact of the discount rate in reducing the present value of the cash flow.

Discount rates are a function of:

- 1) Expected rates of economic growth and associated predictability (general opportunity costs and economic risks);
- 2) Expected long-term rates of inflation (the rate of decline in the value of money); and
- 3) Risk perceptions.

Long-term government bond yields are largely a function of 1) and 2) above. Discount rates that influence stock prices are a function of 1), 2) and 3). If expectations for inflation levels over the long term increase dramatically, this would have a one-off impact on bond yields.

Stocks are attractive relative to bonds, as their future cash flows and intrinsic values can increase. In contrast, bonds have fixed coupons and fixed terminal values with strict time-based payment schedules.

The potential growth in the future cash flows without a maturity date is the most attractive aspect of investing in stocks. Discount rates reduce the present value of future cash flows, whereas future growth rates in free cash flows can increase the present value of a business. Growth in future free cash flows can come from two key areas: 1) sharing in the overall growth of the economy and/or 2) by taking market share from other competitors. As the size of the economic pie grows, businesses share in this growth. In periods of high growth in the economy, sales and profit growth is abundant, because most businesses share in this type of growth. In contrast, growth that comes from taking market share is difficult to obtain organically and is incredibly valuable in a low growth world. This type of growth is not reliant on the overall economy and can be a source of sales and free cash flow growth for a business, even in an economy that is shrinking.

The present value of a stock is potentially negatively impacted if the discount rate increases. All other things being equal, if any of these three factors (outlined above) that comprise the overall discount rate increase, then the present value of the stock will decline. The relevant discount rate is the bridge that connects the expected future free cash flows to the present value.

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