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Interest rate cuts: Implications for investors

Nicholas Riemer, Investment Education Head, FNB Wealth and Investments

Following an unscheduled meeting on Tuesday, the SARB’s Monetary Policy Committee (MPC) unanimously decided to cut the repo rate by another 100 basis points (bps) to 4.25%, leaving the prime lending rate at 7.75%. This was the third Monetary policy committee meeting of the year, and the SARB was once again responding to the devastating impacts of Covid-19, which at this stage, have led to an extension of the SA lockdown from 21 days to 35.

The SARB’s decision to cut rates came on the back of a Covid-19 induced deterioration in global economic conditions. Domestically, the negative impacts of supply and demand effects, are expected to reduce growth significantly, as businesses are forced to shut down and households spend less. Discouragingly, the impacts on employment are expected to be negative.

While recent interest rate cuts will provide relief to households, businesses and consumers in the form of lower debt repayments, a lowering of benchmark interest rates has the following impact on savings and investments.

Cash
A cut in the SARB’s benchmark interest rate will result in less interest on savings and money market accounts. This is typical with any variable interest rate-linked instrument. For those customers with existing fixed interest investments, no change will take place as interest returns on these instruments are locked in. Going forward, however, new fixed interest instruments will be offered at lower interest returns on the back of the rate cut.
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Bonds

Bond yields are expected to decline on the back of a cut in interest rates. This is because bond returns become more attractive relative to cash instruments. Higher demand for bonds usually result in an increase in the price of local bonds and as a result reduction in yields.

Preference shares

Preference share dividends are often linked to the prime interest rate. This means that the distributions received on these linked instruments will be lower when the interest rate goes down. The value of preference shares usually declines in the event of a rate cut.

Property shares

Property shares usually increase in value on the back of an interest rate cut. There are two reasons for this. First, property companies rely on debt to finance properties. The cut in the rate should see a reduction in interest expense and as a result improve the rental yield. Higher rental yields result in larger profits made by those companies and thus we can expect to see an increase in property stocks. Second, property stocks are valued by discounting future expected distributions to the present by using a “risk free rate” – usually the 10-year government bond yield. As bond yields decline, the value of these companies increases.

Equities

 Generally, the value of equities increases when interest rates decline. Like the property sector, this is due to underlying companies receiving the benefit of lower interest rates on debt, and cash flows being discounted to the present using a lower bond yield. Certain companies will benefit more than others.
Retail or consumer-facing shares will benefit most since they will receive the same benefit as other equities but will also theoretically receive a boost in demand for their products. Consumers will be able to access funding at a lower cost, and enjoy lower interest costs on current debt such as mortgages and car payments – with both increasing their spending capacity.

Companies with large amounts of debt on balance sheet will enjoy lower interest expenses going forward, assuming debt is linked to the prime interest rate and not fixed. Lower expenses result in higher profits and headroom for these companies to pay down these high levels of debt.

Banks and insurers will be negatively impacted by interest rate cuts. Interest rates are a key driver for banks, as they determine banks’ net interest margins. A cut in the repo rate does not work in the banks’ favour as a lower rate means lower spreads and thus lower margins. A cut in interest rates will affect life insurance company margins, hedging costs and product sales. Insurers invest premiums in instruments linked to the repo rate. The lower rate could result in a decrease in investment income.

To conclude, the bank’s medium-term forecasts for consumer inflation were revised lower to average 3.6% for 2020 (from 3.8% previously) and 4.5% in 2021 (4.6%). Meanwhile, an inflation outcome of 4.4% (unchanged) is expected for 2022, with overall risks to this outlook being tilted to the downside. The outlook for Growth Domestic Product (GDP) growth was also reduced further, with GDP now expected to contract by 6.1% in 2020 (from -0.2% previously), before recovering to 2.2% (1%) and 2.7% (1.6%) in 2021 and 2022 respectively.
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In line with ongoing weakness in GDP growth momentum and subdued inflation, the SARB’s Quarterly Projection Model (QPM) indicated a further repo rate cut of 25bps each extending into the first quarter of 2021. This means that there is still room for more cuts going forward. Nevertheless, it should be noted that the Quarterly Projection Model only serves as a policy guide and changes rapidly in response to data and risks.

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