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# Interest rate levels affect equity levels

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Equity valuations are impacted by many factors: earnings, cashflows and market sentiment to name but a few. Interest rates play in important part in current prevailing equity valuations and we believe investors should be focussed on these at present because if low interest rates drive higher current equity valuations, then higher interest rates will inevitably drive lower valuations.

The discount rate you use in a discounted cash flow valuation can have a big effect on the company's intrinsic value today. To illustrate, let's use an example based on the following assumptions:

| | |
|---|---|
| Earnings Per Share Year today | £1 |
| Growth Year 1-5 | 12% |
| Growth Year 6-10 | 10% |
| Growth Year 11-15 | 8% |
| Growth Year 16-20 | 6% |
| Growth Year 21-25 | 4% |
| Growth Year 26-30 | 2% |

Under this scenario, for illustration purposes, the net present value of those 30 years' worth of earnings is £45.65 using a risk free rate of 6%. (The current risk free rate is considerably lower but we have used this rate for illustration purposes). However, if we increase the discount rate to 10%, the value of that earnings stream is now only worth £26.43 today. Again, if we raise the rate to 15%, the net present value is reduced to £15.40. the reverse has been true whilst interest rates have been falling since 2008.

Discount rates have a big effect on equity valuations. With interest rates and bond yields continuing to trade at all time lows, the discounted value of future equity cashflows is currently very high. Maybe this is justification for the current high Price/Earnings ratios.

Whilst interest rates remain low and cash flows are maintained by companies, equity market valuations could well remain around current levels. The question we have been asking ourselves however is how interest rates can remain so low across the bond curve whilst companies (as an aggregate) generate the growth rates that have been prevalent over the past five years or so? This is not sustainable at an aggregate level as low interest rates are in place due to a lack of demand (which drives cashflows). The key question is how this dichotomy plays out over the coming years. Whilst many investors are expecting interest rates to rise, we can't help but think that they may regret what they wished for.

For us it is very important at this stage of the investment cycle to only purchase equities with a margin of safety between the current price and intrinsic value of the underlying cashflows. Large segments of the equity markets look overvalued on this basis and we remain concerned by investors' complacency and dare we say it, greed.

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