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Fixation with Rates: Unproductive and Unprofitable?

In recent years, investors have been increasingly fixated on interest rates. How high? How long? When is it coming down? Will it come down? Is this the new normal? The curve is inverted, and steepening! What does this mean? What does history say about rate cycles? And so on and so on.

This is understandable. Interest rates play an outsized role in asset prices. When rates go up, asset prices go down, and vice versa. This is because an asset is worth all its future cash flows discounted to the present day. A higher interest rate means a higher discount rate, which in turn means a lower present-day value of these cash flows. If you can forecast rates correctly, you have a better grasp of the true worth of an asset.

Interest rates are also inextricably tied to investors' expectation of future inflation. We can't divine the future, but interest rates are the closest manifestations of what we think future inflation will be. If long bonds are high, the market is saying that inflation is expected to be high. When inflation was low and steady for so long, nobody really cared but now everybody's talking about inflation.

Well Fed

Given the widespread impact of interest rates, it's no wonder that people are fixated on it. Every Federal Open Market Committee (FOMC) meeting is heavily scrutinized. Every word from Jerome Powell, the Chairman of the Federal Reserve, is dissected. The 24-hour news cycle constantly feeds us analysis of rates and its movement and supposed direction. But is this fixation with interest rates productive? Probably not.

Too Hard Pile

It would be very challenging to earn above-average returns by focusing on predicting where rates are heading. Consider all the breaks required to capture "alpha" from the movement of rates. First, you need to correctly forecast inflation. Why? Long-term interest rates are inflation expectation plus 1-2 percentage points, according to Aswath Damodaran, a prominent finance professor at NYU Stern. If the market expects inflation to be 3%, interest rates should be around 4-5%. After all, why would anyone purposely invest in anything that yields a lower rate of return than the expected inflation?

Now consider how challenging it is to forecast inflation. Central banks such as the Federal Reserve and the Bank of Canada underestimated inflation during the pandemic. Now they too are watching economic data intently to gauge the correct time to cut rates (or to continue to cut rates in Canada's case). Contrary to the idea that central banks authoritatively reveal what the interest rate is and thereby dictate everyone's fortunes, another school of thought is that central banks are actually reactionary. That is, economic data drives interest rates rather than the other way around. Markets and the economy are "complex adaptive systems" so there's likely no correct answer to the direction of causation. But the reality is that central banks are as mystified as the rest of us. And if they can't forecast inflation with confidence, then it seems imprudent to believe that an individual investor can.

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Now let's say you have a strong opinion that inflation is under control and that the Fed will cut rates in September. And you're correct. Is this profitable? This would depend on what the market expects and prices in. To reap above-average returns, you have to correctly predict inflation, the resultant interest rate movement, and not have either one of these predictions be priced in the market already! For example, if lower rates benefit a utility stock, is a future rate decrease already priced in? If so, there is no profit to be made here as the stock price would already reflect this rate cut.

None of the above even mentions the complexities of the yield curve, which is typically upward sloping since investors demand higher treasury yields to compensate for the increasing uncertainty farther into the future. How does the change in the target interest rate affect the shape of the yield curve? One study showed that a steepening yield curve benefited "risk-on" assets such as small cap and emerging market stocks; conversely, an inverting yield curve benefitted "risk-off" assets such as U.S. Treasuries and utilities. These relationships make some theoretical sense, but they are not guaranteed like the laws of physics.

Back to Basics

So, what is an investor to do? At Sionna, we think that all roads lead back to investing for value and managing risks, starting at the company level. Estimate the intrinsic value of a company and invest when there's a sufficient margin of safety. Concurrently, manage risks with rigorous fundamental research and portfolio diversification. There is no silver bullet to above-average, risk-adjusted returns. But value investing, when done well, is as close as it gets in our opinion.

Fundamentals are Calling

Take our approach with a couple of telco stocks – Rogers and Quebecor. While a lower interest rate environment may benefit these yield-oriented stocks, our thesis for each investment does not rely on this scenario. The market is currently down on these stocks, but we believe that the pressures on this sector and each specific company are temporary in nature. For instance, investors are worried about the level of competition in this sector. While it is heightened at the moment, studying the history of this sector reveals that competition comes and goes. It will ease in the future as this phase of competition cycles through.

Another short-term concern is that population growth is slowing. Prior to the federal government's announcement that immigration will trend down, immigration was breaking records. Without this support, investors worry that growth in the telcos will suffer. However, slowing immigration is very different from population decline. In fact, Canada's population growth in 2023 was the fastest since 1957. Immigration is still going to add incremental growth, providing a tailwind for these companies; it just won't be record-breaking.

Lastly, there are concerns that the debt levels at these companies are high. While their absolute level of debt is higher than an average company in the TSX, these are not average companies. Telcos are amongst the most cash-generative and recession-resistant companies in the Index. They are treated as "yieldcos" because their predictable cash flows enable them to pay steady and growing dividends year after year. And if the economy slumps into a recession, demand for their products tend to not wane the way that discretionary products would. This is because owning a phone and using the internet are likened to keeping the lights on. They are utilities that people tend not to live without. As such, companies in the telco sector, which operates as an oligopoly in Canada by the way, can manage more debt than the average company in the Index.

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Since the acquisition of Shaw, Rogers has done a fantastic job of growing its business, realizing synergies higher and faster than management's initial guidance, while steadily paying down its debt. Given the company's strong cash flows, relatively low dividend payout ratio (unlike some of its peers), and asset sales that have progressed as planned, there is a clear path for Rogers to continue its deleveraging journey.

As for Quebecor, its strong presence in Quebec and growth from its Freedom acquisition are all supportive of its recent deleveraging journey as well. Given this, Quebecor's credit rating was recently upgraded to Investment Grade by both S&P and Moody's.

All in all, while rates will affect these stocks, our investment theses do not rely on rates to go one way or another. We do fundamental research and have a differentiated opinion. The sector and companies' pressures are temporary, and valuations are at historical lows, providing fertile ground for attractive returns.

Awareness, Not Fixation

Perhaps it is easier to watch the news and read about interest rates than it is to roll up your sleeves and read a company's annual report. Perhaps it is part of everyday conversation so discussing rates and inflation come naturally. Perhaps it is just plain fun to forecast and wager. We think that being overly fixated on rates is unlikely to be productive or profitable. Be aware of interest rates, but hold your opinion lightly, and get back to the basics and invest for value. This is what Sionna believes to be the best path to protecting and growing capital over the long run.

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