RBA increases Interest Rate: Should equity investors be worried?

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THE RESERVE BANK of Australia finally succumbed to the increasing inflation and announced a 0.25% interest rate increase. According to most of the experts, this was along the lines expected and if the consensus is to be believed we could expect the interest rate to go up as high as 3% by the end of this year.

This is a significant increase in the interest rates, although the RBA Governor has refused to comment on whether this will indeed happen.

However, the interest rate increases can cause investors to worry that increasing interest rates may result in declining equity valuation and therefore poor expected returns for equity investors.

However, as is always the case we look back in history to assess whether this is how it has panned out indeed. Again, US markets offer the most historical data and as such an indication of what has happened in the past.

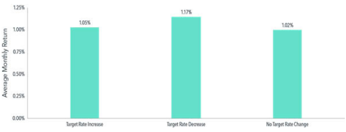
Generally looking back – equity returns in the US have been positive on average following increases in interest rates by the Federal Reserve.

Analysing the US Federal Reserve data on interest rate changes between 1983 to 2021, interest rates increased in 70 months and decreased in 67 months over the 468 months in total.

As you can see in the chart below, on average monthly returns of US equities are positive with increases in target rates.

Importantly, the average stock return in months where the interest rate was increased is similar to the average return in months with decreases or no changes in target rates.

US Equity Market Returns and Federal Reserve Funds rate change, January 1983 – December 2021



In the months after the hikes, particularly consecutive hikes, the data indicates that the US equity markets delivered strong long-term results regardless of what the Federal Reserve did.

With several months remaining in 2022, the signals from US Fed Reserve and closer home from the RBA will be monitored closely.

More often than not, the agenda is signalled ahead of the meeting and to that extent, the market prices already incorporate the information.

It is but natural to wonder what the action by the Fed/RBA would mean for equity performance, what the data available for the US markets indicates is that reducing equity allocations in anticipation of, or as a reaction to these movements is unlikely to lead to a better investment outcome.

As an investor, you are better off continuing to hold a well-diversified portfolio that is customised to your specific circumstances and goals which will ensure you are best placed for long-term investment success.