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How inflation risks affect stock prices?

By: Henry Ong

It is a common notion that when interest rates increase, the stock market tends to fall because fixed income securities become more attractive due to higher yields.

The recent market correction in the PSE Index, which wiped out all the gains made last month, was caused apparently by fears of rising interest rates stemming from possible rate hike in the US. This was aggravated by the January inflation of 4 percent, was the highest in three years.

Although the rate was within government projection, it was at the upper band of the range, which could suggest further rise in prices of goods during the year.

When inflation is expected to rise, one would expect that interest rates will follow soon. Already, the 10-year treasury note yield has increased by 100 basis points to 6.7 percent from 5.7 percent in December in anticipation of an interest rate hike.

Whether the rates will really rise or not, the uncertainty will be discounted in stock prices. This uncertainty is referred to in the market as equity risk premium.

As investing in stocks is riskier that investing in fixed income, it is rational to expect investors to add a premium on top of the prevailing yield from fixed income to compensate for the extra risk.

The greater the uncertainty, the higher the equity risk premium. A high risk premium can lead to higher rate of return from equities, which demand lower stock prices.

Historically, the PSE Index has an inverse relationship with rate of return over the past 10 years with a high correlation of 48 percent. This means that when the required return increases, the PSE index falls in 48 percent of the time, and vice versa.

The current rate of return of the market can be computed by taking the earnings yield, which is simply the inverse of market P/E of 19.2x or 5.2 percent plus the long-term earnings growth rate, which we assume to equal GDP growth rate of 7 percent.

The sum of 12.2 percent represents the minimum return any average investor can expect to earn by investing in stocks at current prices. But before the market fell to profit taking, the rate of return was at 11.9 percent when the PSE index was at its record high.

The 10-year Philippine treasury yield at the start of the year was 5.7 percent. When the PSE index succumbed to correction, the yield was 6 percent. The rise in yield continued to 6.7 percent, bringing the market to its present level.

Note that what has been raising the level of riskiness in the market with higher required return so far was the rising treasury yields and not risk premium.

The implied equity risk premium, which is computed by deducting market yield from required return, has been declining from 6.7 percent in December to 5.9 percent and to 5.5 percent at present.

Why is the equity risk premium declining when the market has been falling with pressures of higher inflation and interest rates?

One reason can be that despite the recent market selloffs, economic and corporate fundamentals have remained intact. Nothing has significantly changed that may merit downgrade in equities valuation so far.

The other reason can be that investors look at equities as perfect hedges against inflation. The expected increase in inflation in anticipation of a stronger economy makes equities an attractive defensive investment.

Stocks that can offer potential hedge against inflation are those that have relatively low equity risk premium.

Among the 30 PSE Index stocks, about half have risk premium of less than median of 5.5 percent.

Among the top stocks on the list include SM Investment (3.1 percent), SM Prime Holdings (2.9 percent), Jollibee (2.6 percent), JG Summit (2.1 percent), Ayala Land (4 percent), Ayala Corp (5.1 percent), ICTSI (4.6 percent), BDO (4.4 percent), BPI (5 percent) and Universal Robina (5.1 percent).

While it is true that risks of rising interest rate as a result of higher inflation may affect stock market returns, the impact on individual stocks may not be the same because of varying levels of riskiness.

In times of uncertainties, it is always good to buy stocks with sound fundamentals. INQ

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