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## Navigating Rising Rates Across the Globe

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Rising inflation has central banks around the world trying to determine the future path of interest rates. Though we don't know where terminal rates will reside, and it will be different for each economy, the path in most cases is higher. The debate is how quickly and how aggressively central banks will respond as the era of central bank support fades.

We sat down with our international analysts to discuss how this shift impacts businesses and investment opportunities across the globe. Here are their insights.

**Yiting Liu, CFA:** One of the areas I cover from a research perspective is banks, so I'll chime in first. Generally speaking, policy rate hikes by central banks are usually a tailwind for most banks in terms of higher net interest margin/net interest income, assuming you have the correct loan and deposit book structure. But it's important to keep in mind that central banks in different countries are at different stages of the interest rate hiking cycle, so broad generalities are harder to make.

For example, in developed markets, the UK might be one of the first countries to reach its peak interest rate, while market consensus is still being built in Japan regarding policy divergence with other major economies. If you look at some large emerging markets countries like Brazil, they are much further ahead of many developed market countries in terms of the hiking cycle. In fact, Brazil is probably on the tail end of it. Other emerging markets like Indonesia and India started raising rates only recently, as policymakers believed economic recoveries were still in progress and policy support was needed. Then you have China, which is dealing with its own issues of slowing economic growth, its zero-COVID policy, political transition and monetary easing.

As bottom-up investors, we don't make investment decisions based on the interest rate cycle or any other macro factors. We try to find the best investment opportunities that we believe have the potential to compound value over time, across all cycles. The full interest rate cycle — the up and down and how that translates into a normalized net interest margin on a five-year horizon — is just one of several inputs or factors that I consider when estimating intrinsic value for a bank.



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Again, a rate hiking cycle is typically a boost to banks' top-line revenue, everything else equal – which is never the case. Banks may plow that extra top-line revenue back into investments or capex. It may cost them more to operate their existing franchise in a higher inflationary environment. Other factors to consider include the pace and magnitude of the tightening cycle for these central banks and how much it has impacted the underlying economy, long-term loan demand and borrowers' ability to pay, which impact banks' asset quality. Last but not least, in certain European countries, levy/legislation could be imposed on banks to offset the cost-of-living crisis, thereby reducing the benefits of higher rates to banks.

**Chris Piel, CFA:** If you think back two years ago, it was full, pedal-to-the-metal stimulus from central banks in response to the global pandemic. Now, here we are nearly two years later and it's almost full speed in the other direction, trying to cool things off. You can see how volatile and how quickly the environment can change in a pretty short period of time.

Across consumer, industrial and technology – areas that I cover from a research perspective – it will likely be a mixed bag in terms of the impact from a rising interest rate environment. For example, for some of the growthier companies that derive a lot of their cash flows (and thus intrinsic value) in future years and generate very little cash in the interim, the valuations of these businesses might be more negatively impacted by rising rates, assuming the equity risk premium stays flat. On the other side, as Yiting mentioned, there are some tailwinds with rising interest rates for banks, so these businesses may benefit from the higher rate environment. Somewhere in the middle, we have a lot of good companies with strong balance sheets and solid cash generation that may show little impact. These businesses also have the ability to invest and fund future growth either with the cash that is on hand or through the cash flows they are generating, which helps them avoid the need to rely heavily on expensive capital markets during a rising rate environment.

In the Diamond Hill International strategy, we have a diversified portfolio of companies, so they are all going to be impacted in different ways from rising rates. But again, we are intrinsic value investors who use a bottom-up, fundamental approach to evaluating investment opportunities. Our goal is to incorporate, to the best of our ability, all the different factors that could impact a business's intrinsic value. If we can incorporate these factors under a range of different scenarios and still invest with a margin of safety (or discount to our estimate of intrinsic value), then this margin of safety allows room to account for various unforeseen circumstances, or unexpected policy shifts, for example, that perhaps weren't factored into our original valuation assumptions.

**Chendhore Veerappan, PhD, CFA:** I can offer another example using the health care sector. I think smaller, more local players may struggle a bit more in the current environment. For example, there are smaller companies in the health care space that are more focused on innovation and thus require a large amount of capital to generate future cash flows down the line. These companies that depend on external capital for future growth are more exposed to a rising interest rate environment, so they essentially have a duration risk embedded in them.

Other companies are more global in nature and have more mature business models, such as global pharmaceutical companies or global medical device companies. These types of businesses have the potential to benefit from a rising rate environment because they typically have high free cash flow and strong balance sheets to help them weather a more challenging environment.

The other characteristic of health care is that demand for health care is pretty inelastic. You could delay your elective surgery or routine visits for a few quarters or even a year or two, but eventually you're going to need or want those services. Given the nature of health care and the fact that many businesses are able to pass on price increases and also maintain good margins over time, it's an area of the market that is relatively well positioned for this type of environment.

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