



Impact of interest rates and inflation on investing

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Importance of the discount rate

10-year 5% semi-annual par bond is issued.

What is it worth in one year's time?

That depends on the prevailing discount rate in one year's time.

- Discounted at 6%, the bond would be worth \$93 and your total return would be -2%.
- Discounted at 4%, the bond would be worth \$108 and your total return would be 13%.
- Remember: the bond matures at \$100, but differences in the reinvestment rates and future purchasing power are constantly calculated until maturity.

Duration risk in dollar terms

For every 1% rise in yields over a one-year time horizon:

- 2-year bond suffers a capital loss of \$1.85
- 5-year bond suffers a capital loss of \$4.75
- 10-year bond suffers a capital loss of \$8.75
- 30-year bond suffers a capital loss of \$19.00

How leverage can deliver a margin call

- Assume an apartment building produces a \$100,000 annual net operating income (NOI) in perpetuity.
- Using a cap rate of 5.00% the building would be valued at \$2mm.
- A buyer with a 25% down payment buys the building for \$2mm (\$500k down + \$1.5mm borrowed).
- A rise in the cap rate to 6.67% reduces the value of the future annual NOI to \$1.5mm.
- The buyer's equity is wiped out and the bank demands more capital. Otherwise, the bank will seize the property.
- Recognize that the NOI is held constant; it's the increased cap rate that has negatively changed the present value of the asset's cash flows.

30-year U.S. government real yields



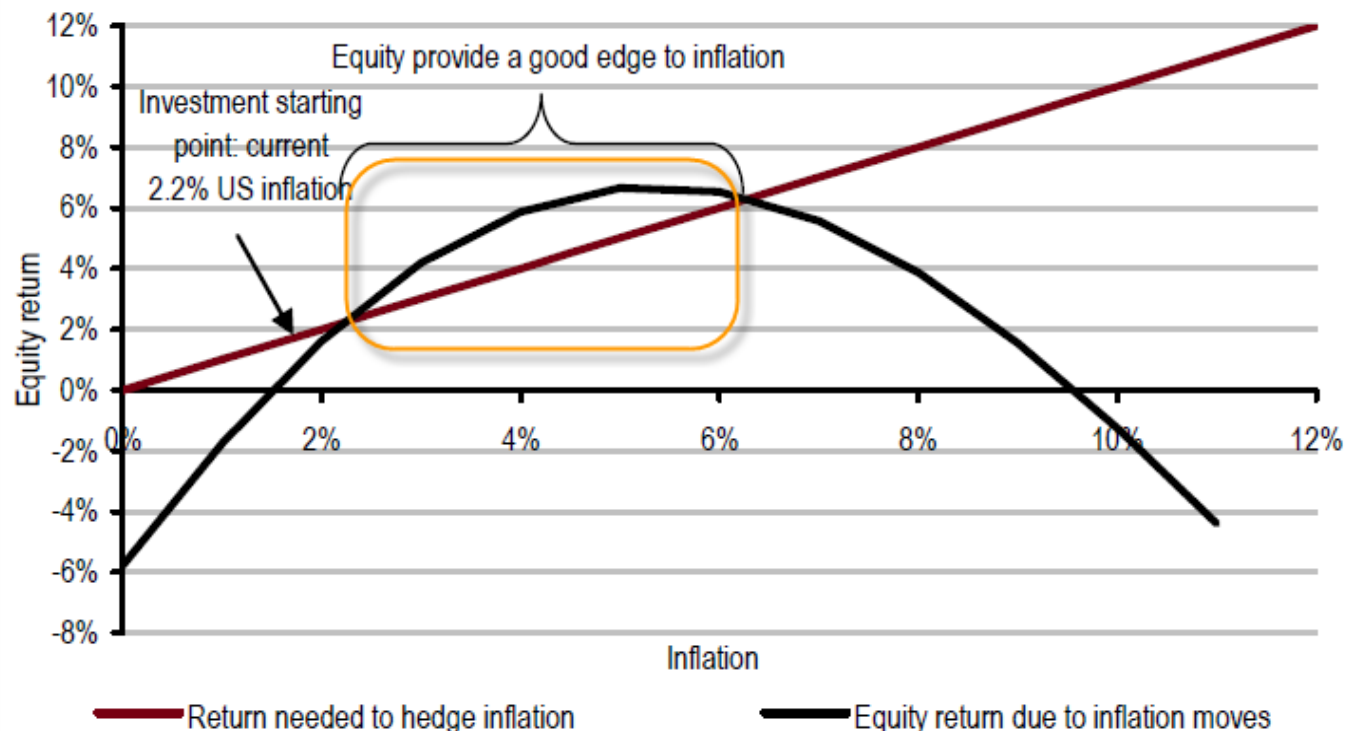
Source: Bloomberg L.P., as at March 15, 2013.

Equities as an inflation hedge?

Equity return depending on inflation level.

Equities only provide an inflation hedge if inflation increases to 6.5%.

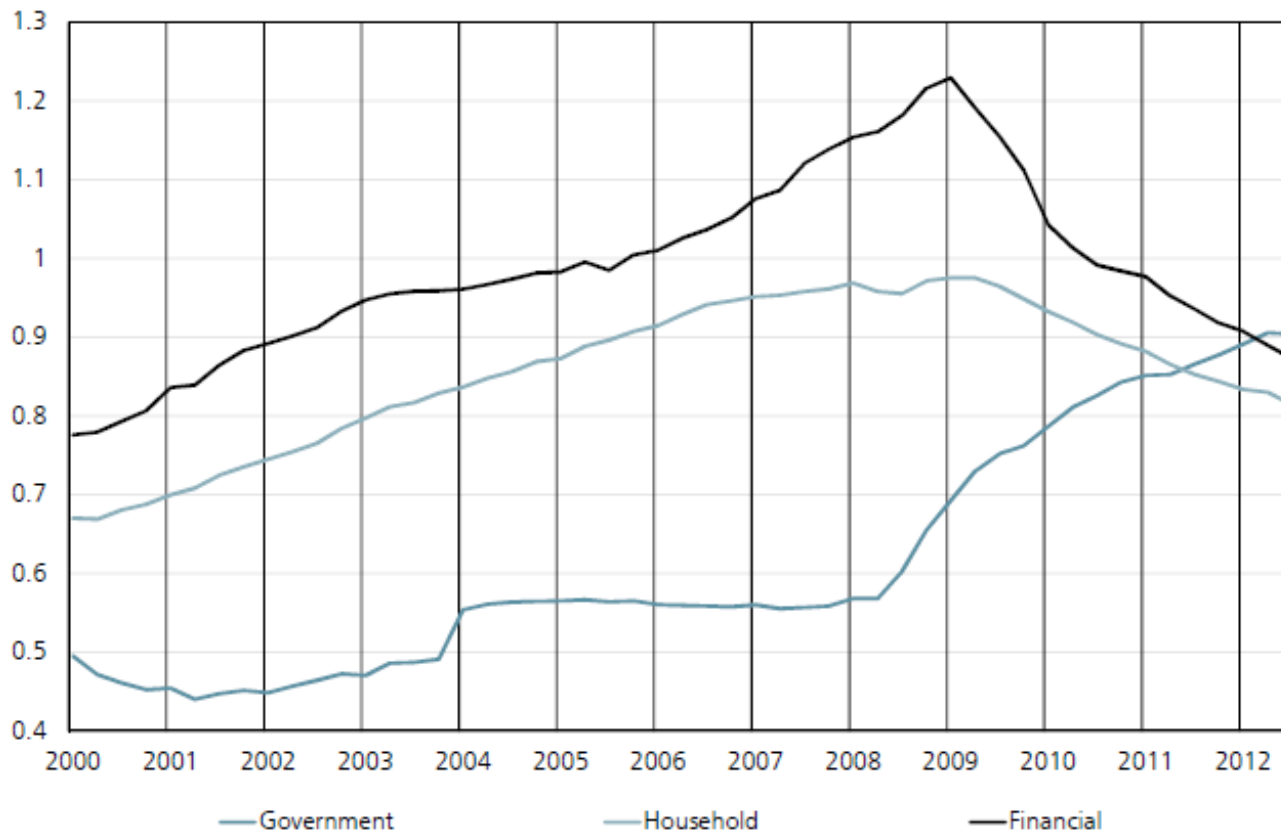
Above that, the valuation argument destroys the protection.



Source: UBS

The secular headwind

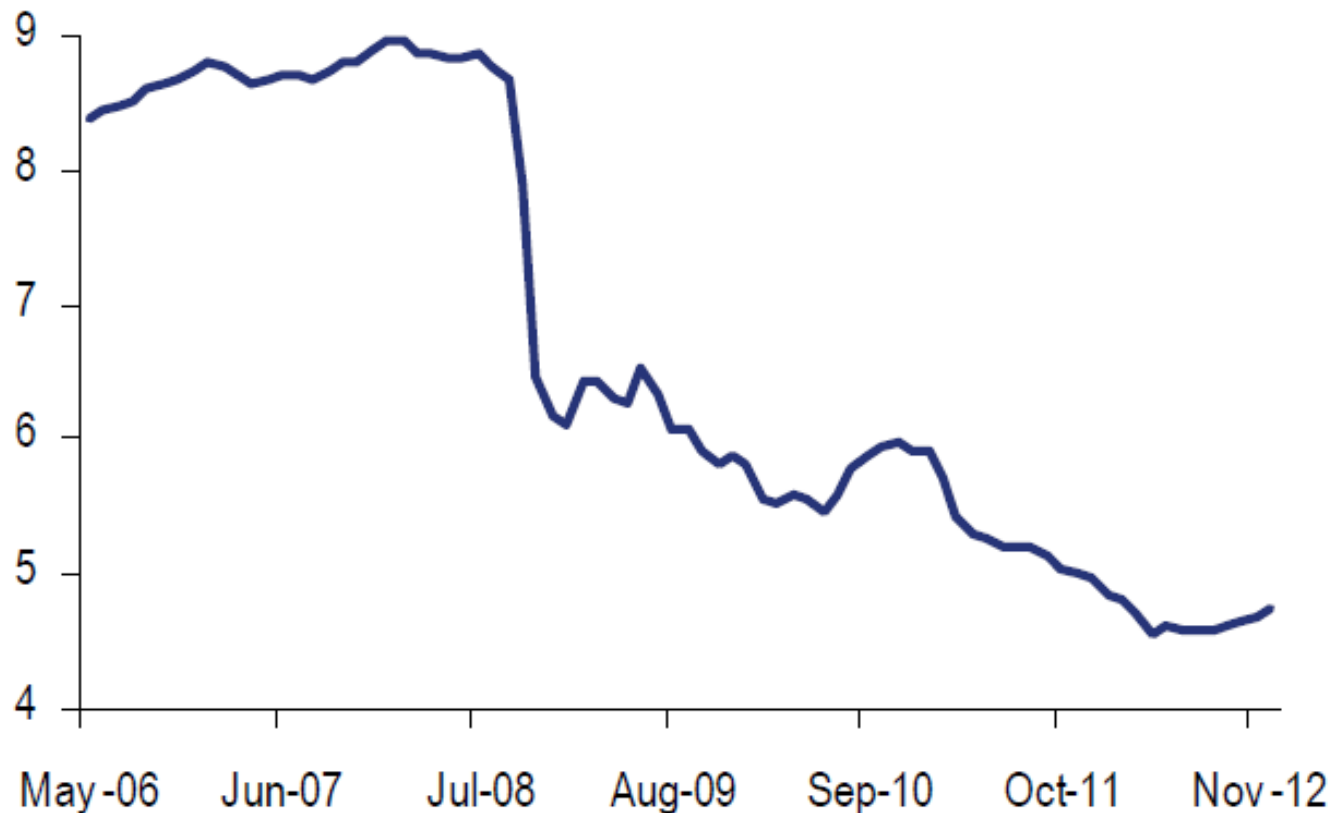
U.S. Debt/GDP (government, households and financials)



Source: J&E Davy

Premature to call a reversal but this is what every central banker is following

Global money multiplier (index)



Source: BofA Merrill Lynch Global Research

Questions