Letter n°88

Rising interest rates, what are the risks for the markets?

"To learn to see, to distinguish, to describe what is in front of our eyes" Husserl.

Clearly, in the span of two years, the world has changed, and as a result the ways in which markets are interpreted must evolve. It is advisable to heed the advice of the philosopher Husserl. Assets considered risk-free in a context of zero or negative interest rates are now vulnerable. The high valuations of growth companies are exposed. The comfort provided by high-dividend companies is being questioned, and one can provide numerous examples in this Letter 88.

- ***The memory of low interest rates***:

After the 2008 financial crisis, public debt increased almost everywhere in the world, but the cost of debt did not worsen because there was a decrease in investment needs, an excess of savings from aging populations ("saving glut"), and liquidity injections, resulting in low or even negative interest rates for major countries.

As a consequence of this low-interest-rate policy, there was an inflation in asset prices, an increase in inequality, and a misallocation of capital, but GDP growth was not stimulated. There was a proliferation of "zombie" companies, a lot of unproductive investments, and many large corporations took advantage of low-cost borrowing to acquire competitors at high prices, strengthening their dominant position, and thereby losing incentives to invest and innovate.

The outcome is not flattering because, according to the UN, in 20 years, global public debt, $9.2 trillion, has increased fivefold, while GDP has only increased by three times.

- ***The emergence of rate hikes***:

A year ago, the interest rate hikes decided by central banks were driven by monetary policy tightening, concerns about wage inflation, and apprehensions about sustained inflation.

Today, long-term interest rates continue to rise as markets worry about the worsening of public debts and the interest burden on this debt if rates remain persistently high. This marks the return of the famous risk premium that has long been overshadowed by "quantitative easing.".

In addition to this fear, there are structural factors, the end of cheap energy in the context of energy transition, the cost of this transition for states, the prospect of increased military budgets, and the impact of aging on healthcare and retirement expenditures.

Persistently high long-term interest rates are the worry raised by Powell's recent statements at the helm of the Fed. These statements are justified by the apparent strength of economic growth and positive employment figures. They are also motivated by the recent rise in oil prices.

However, interest rate hikes raise concerns of a slide into a recession, which has been avoided so far.

Less than a month ago, expectations for long-term interest rates by the end of 2024 were at 4.2%, but now they have risen to 4.8% as markets anticipate a continuation of central banks' balance sheet reduction in a context of insufficient savings to finance various needs.

To better understand the risks, we will analyse the fears for states, fears for indebted companies, fears for households, and fears for the markets in turn.

Fears for the states:

In Western countries:

- The financial environment:

Today, global public debt stands at 90% of the global GDP, with five G7 countries having public debt exceeding 100% of their GDP.

Overall, since the rise in interest rates began, there has been an increase of 5.2 points in the United States, 5.1 points in the United Kingdom, and 4.25 points in the Eurozone.

After the downgrade of the United States' AAA credit rating, the club of AAA-rated countries, the least indebted, with the three credit rating agencies, is reduced to Switzerland, Germany, Australia, Norway, Luxembourg, Singapore, the Netherlands, Sweden, and Denmark.

The additional budgetary needs of states are substantial: about 0.5% of GDP for incentives for reindustrialization and approximately 2% for energy transition. Global savings surpluses are being absorbed, and thus, there will be higher long-term interest rates.

- United States:

In the United States, the outstanding Treasury bonds went from $5 trillion at the beginning of 2008 to $25 trillion. In July, 2-year interest rates were 1.1 points higher than the 10-year rates, a record for the past 40 years. Since then, the spread has been reduced to 0.3 points because long-term rates have increased significantly.

In 2007, the 10-year rates were at 4.6%, but the US public debt did not exceed 35% of the GDP. Today, it is hovering around 100% of the GDP.

According to Fitch, the debt service is increased by 25% to $650 billion, representing 2.5% of the GDP, and in the coming years, it will inevitably increase because the budget deficit is high at 6.5% of the GDP for the fiscal year ending on 30 September 2023, totalling $1.7 trillion compared to 5.5% in 2022.

- Europe:

In Europe, long-term interest rates, except in Italy and the United Kingdom, and thus the cost of debt, are lower than in the United States. Currently, concerns are focused on Italy, a highly indebted country with a debt-to-GDP ratio of 140% for public debt alone, and a country not very concerned with budget orthodoxy as the Meloni government is considering a budget deficit of 4.3% of GDP in 2024, against the backdrop of an optimistic GDP growth forecast of 1.2%.

Even in Germany, the public debt service is a concern, as it has increased from €4 billion in 2021 to €30 billion this year, according to Fitch.

In France, public debt was 21% of the GDP in 1980, 67% in 2007, 98% in 2019, and it is now approaching 110%. The cost of debt, which was negative in 2021, is currently at 3.50%. The interest burden, €36 billion in 2020, will reach €52 billion this year, and the increase will continue because the debt maturity is between 7 and 8 years.

In emerging countries:

- China:

In China, according to the IMF, the combined debt of the state, provinces, and local authorities, including Local Government Financing Vehicles (LGFV) responsible for financing infrastructure, has reached 120% of GDP and is expected to reach 150% by 2027, according to the IMF. This debt adds to the debt of businesses and households and represents a total of three times the GDP, a very high level for an emerging country, even though this debt is financed by local savings in yuan.

- Other emerging countries:

The rise in interest rates and the depreciation of currencies in many emerging countries are destabilizing many of these countries.

Since the beginning of 2022, the borrowing costs for countries rated C, the most indebted, have increased by 14 points, restricting the possibility of growth and necessitating debt relief measures. Western countries are urging China, a major lender in recent years, to reduce the debt burden, but China is reluctant to do so. China would like to change the rules so that the IMF and the World Bank relinquish their status as preferred creditors and give up a portion of their claims. The World Bank refuses to do so for fear of a credit rating downgrade, which would prevent it from lending at low interest rates.

Increasing the lending capacity of the World Bank will not solve the problem.

Therefore, the focus is on creditors, and there is no talk of debt reduction. Debt rescheduling is under consideration at most. This is expected to be the case for the agreement being finalized with Zambia. This is likely to be the challenge in the coming months for many sub-Saharan African countries.

The riskiest countries include Ethiopia, with a spread of 50 points compared to the United States, Tunisia at 35 points, Pakistan over 20 points, Ghana, and in general, about 20 countries are at risk of default.

Fears for indebted companies:

Over the past 15 years, the low-interest-rate environment was not discriminating, and even indebted companies managed to secure funding at very attractive rates. That period is now over, and indebted companies are struggling with their business models being undermined because refinancing has become costly.

- In the United States:

The average interest rates on investment-grade bonds in dollars are at 6%, compared to 1.9% at the end of 2020. For "junk bonds," the average rates are at 9%, compared to 4.5% in 2021, and the issuances since the beginning of the year represent a little over $100 billion.

Defaults in the "junk bonds" market, valued at $1.4 trillion, have been increasing since the start of the year. There are nearly 20 defaults totalling over $20 billion, i.e. more in the first five months than in the two years of 2021 and 2022.

Faced with banks' reluctance to lend, indebted companies are turning to the private debt market. According to Preqin, the private debt market has exploded, from $300 billion in 2010 to $1.5 trillion today because, compared to banks, private debt funds do not have the same constraints.

Reflecting these concerns, the Russell 2000 index of small-cap stocks in the United States, at 1,736, has fallen by 11% since its peak on 31 July at 2,003, and by nearly 30% since its all-time high in August 2021 at over 2,400. It's worth noting that nearly a third of the companies in the Russell 2000 rely on variable-rate financing and are therefore vulnerable to successive interest rate hikes. Small companies have always been more dependent on bank loans than larger ones, and today they are facing credit restrictions. Concerns are also affecting regional banks in the U.S., and Moody's has downgraded the ratings of about a dozen small banks.

The S&P 500 itself is down by nearly 10% from its highs on 31 July, even though only 5% of companies rely on variable interest rates.

In response to the rising interest rates, companies tend to borrow over shorter durations, reinforcing the idea of high rates for a brief period. In the United States, the investment-grade bond market, with $8.6 trillion in outstanding debt, has shifted from an average maturity of 16 years in 2021 to 10.5 years.

The default rate has recently risen to 3% compared to 1% in 2021 and an average rate below 2% since 2010, as reported by Fitch. According to the rating agency, this rate could rise to 4.5% in 2024, but there is no cause for alarm at this point compared to the 10% observed during the 2008 financial crisis.

- In Europe:

The default rate has increased from 1% to 3.4% according to S&P and is expected to reach 3.7% in 2024. This is nothing compared to the 9% observed in 2008, but the rise in interest rates has been detrimental to the independence of the Casino Group and is weakening other indebted companies such as Altice.

Fears for households:

To date, especially in the United States, consumption has resisted the impact of interest rate hikes. Only 20% of household debt is at variable interest rates, and debt service represents only 9.6% of their gross disposable income, compared to over 13% in 2008. However, given the prolongation and amplification of this phenomenon, some are concerned.

In the real estate sector, the 30-year mortgage rate in the United States is now at 7.50%. Everywhere, there is a drop in real estate transactions, but prices are holding up because inventories are often low. This is a difference from the 2008 crisis. The most exposed segment is commercial real estate.

The total debt of households amounts to $17.06 trillion, with non-real estate household debt reaching $3.8 trillion, of which $1.6 trillion is from the 43 million student loans, $1.4 trillion from auto loans, and the rest from credit cards, with outstanding balances surpassing $1 trillion for the first time in the second quarter.

On the savings side, the amount of funds placed in money market funds, $5.4 trillion, has never been higher.

Fears for the markets:

- ***Equity markets***:

The rise in long-term interest rates affects the valuation of stocks. Let's not be deceived by the performance of the S&P 500, which is biased by the gains of a few stocks. In reality, the same index with equally weighted stocks is showing a decline since the beginning of the year.

Certainly, banking stocks benefit from the rise in interest rates. This is evident in the third-quarter results of American banks, with a 35% increase to over $13 billion for JP Morgan and a $5.8 billion increase for Wells Fargo, representing a 60% increase over the past year. However, this sector does not have much weight in the S&P 500 index.

Despite the abundance of liquidity, technology stocks, including the FAANG group, are suffering from rising interest rates because their price-to-earnings ratios (PER) are high. Microsoft is trading at 27x, Apple at 26x, levels higher than their ten-year averages of 23x and 17x. The large tech companies, flush with cash, appear to be emerging as winners again from this rise in interest rates. According to S&P Capital IQ data, in the one year ending in June, the top seven tech companies had earned $13.3 billion in interest income, a figure higher than their financial expenses, which were estimated at $9.6 billion.

Other losers of the rising interest rates are stocks that were traditionally attractive due to their dividends, which used to be higher than interest rates, but are now lower.

Small-cap stocks, rightly or wrongly considered more exposed to a potential recession, are correcting more than large-cap stocks.

- ***Bond markets***:

The year 2022 had been the worst for bond markets in the past 50 years, and hopes were raised for 2023, which were met in the early months but disappointed during the summer. This is because we are witnessing a rise in both short-term and long-term interest rates, potentially leading to bond markets closing a third year in decline.

In the United States, the reduction of the Fed's balance sheet since March 2022, -$1 trillion to $8 trillion, is one of the causes of the tension in interest rates. The two-year Treasury yields are at 5%, while the ten-year yields are at 4.60%, far from the 3.80% seen in June.

- ***Currency markets***:

The winner of the rise in interest rates is the $. The losers are the currencies of emerging countries, especially if they are debt denominated in foreign currencies. An illustrative example is the difficulty Argentina is facing in avoiding yet another default.

Conclusion: "***Anyone desiring a quiet life has done badly to be born in the twentieth century" Trotsky.***

As incongruous as it may seem, let's conclude with this quote from Trotsky, which resonates with the magnitude of the challenges investors must adapt to. In summary, we will conclude this Letter 88 with four remarks, not necessarily alarming:

- ***Disinflation continues***: the increase in energy and food prices is modest, and wage growth remains under control.

- ***The resilience of long-term rates***: in most countries, expectations for increased state involvement in the costs of energy transition, national defence efforts, healthcare coverage, and the retirement expenses of aging populations contribute to a further increase in debt ratios and, consequently, tensions on long-term interest rates.

  The initial interest rate tensions in 2022 and the first half of 2023 were due to inflation, while the recent tensions arise from concerns about the budget trajectory of states (e.g., a high budget deficit in the United States) or the solvency of already indebted countries, such as Italy. In 2024, the rate cuts will be slower than previously anticipated, at 5.1% in the United States, according to the Fed, rather than the four rate cuts that were expected not long ago by the market.

- ***The rise in long-term rates is not incompatible with growth***: many have forgotten the strong economic growth between 1982 and 1990, despite high-interest rates. The same was true in the 1990s and between 2002 and 2007. Conversely, global growth did not benefit from zero or negative rates, and debt grew dangerously. So, let's not be too pessimistic. In the short term, the rise in rates penalizes home construction and investment, and it puts pressure on fragile businesses. However, once stabilised, even at a high level, interest rates are not an obstacle to growth.

- ***Some assets penalised***: while the period of zero or negative rates had smoothed conditions for lightly indebted and heavily indebted companies, the rise in rates is increasing risk premiums for small companies and indebted companies. It widens credit spreads, worsens default rates for indebted companies, encourages a focus on high-quality stocks and bonds, weakens private equity funds, hurts gold, which has declined by 6% recently, and dividend-paying stocks like utilities. Conversely, the performance of bonds, which was very poor in 2022 and disappointing in 2023, is expected to improve, but we will not see the long-term rates of two years ago again.

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Bruno Desgardins

Bruno Desgardins
CIO
Switzerland

SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@singalliance.com

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@singalliance.com

SingAlliance (Hong Kong) Ltd
Unit 904-907, 9/F Dah Sing Financial Centre
248 Queen's Road East
Wanchai, Hong Kong
T: +852 2639 3659
E: info.hongkong@singalliance.com

SingAlliance Pte Ltd
(DIFC Representative Office)
The Gate, Level 13 East, Office 10, DIFC
PO Box 121208 Dubai, UAE
T: +971 (0) 4 401 9158
E: info.dubai@singalliance.com