Haven Global Partners, LLC.
Market Outlook: 3Q 2023

2023: Interest Rates Return to Rule the World

The gray-haired among us will remember a time long ago, foreign to many if not most of today's market participants: a time when interest rates mattered. That time may well have returned and prudent investors in today's markets, even pure equity investors, would be well served to pay much closer attention to what is going on in bond markets in order to appreciate where global equity markets are likely headed. To set the stage, in August 1987 dinosaurs ruled the earth and Alan Greenspan (he of the "Greenspan Put") took over as the Chairman of the Federal Reserve Bank of the United States. From that day to this the average yield on the US Treasury 10-year note has been 4.6% which ironically is almost exactly where the yield on that note sits today. So, a quick check of history reveals that today's level of yields which have not been seen by market participants since before the Global Financial Crisis are more like normal than the yields which have been on offer since the GFC. The average US 10-year yield since the end of the GFC (Summer of 2009) has been 2¼%. So, the average 10-year yield from the end of the GFC until now is actually only about half the normal rate (2.25%) that it has been over the 37-year period since Greenspan took over (4.6%).

The title of this Market Outlook refers to the "Return of Interest Rates" well, where did they go? When the Great Recession of 2007 brought the global economy to a halt, the central banks of the world coordinated a rate reduction regime in order to prevent things from deteriorating into another Great Depression. This worked but left us living in a world where interest rates were stuck at almost zero. The obvious question to ask then would be why are they back ostensibly, above zero? Well, the global economy is experiencing a pretty strong bout of inflation and that requires higher interest rates to rein in aggregate demand. Finally, why does it matter to global equity investors?

At the beginning of September when the Employment Report for August came out, all the talk was of the Fed pulling off a soft-landing where a Goldilocks economy was forged by the Fed in which higher rates slowed the economy but did not strangle it to the point where demand and wages slowed but did not crash. Unfortunately, higher rates make it harder for the Fed to achieve that soft landing, and as the Goldilocks scenarios have faded, market observers have pushed back on expectations for rate cuts from the Fed as it appears the Greenspan Put is-finally, dead! If in fact, interest rates remain higher for longer, stocks probably won't. The evidence is starting to show that equity markets are becoming uncomfortable with the level of interest rates. Cyclical stocks have stopped outperforming defensive ones.

Although, unlike last century, company profits are not slaves to interest rate levels the way they used to be. This is because companies now rely less on short-term borrowings such as commercial paper or bank loans. They use private credit markets with longer maturities and fixed rates. Their money market issuance is down about 45% since the GFC while at the same time, their use debt markets has ballooned from $2 trillion to $8 trillion. Meanwhile, global private credit has grown by $1 trillion. Most of those borrowings are fixed rate with maturities averaging more than five years.

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This lengthens the time it takes for corporate debt-servicing costs to rise when the Fed raises interest rates. We have all been hearing from the Fed that the markets react to Fed rate hikes with “long and variable” lags. Well, this corporate debt shield makes that lag longer. There are even more structural changes in corporate finance which have sheltered the corporate sector from the harshest impacts of what has otherwise been an extremely aggressive series of Fed rate hikes. Several companies across many sectors are reporting falling net interest costs, this is happening during a time when interest rates are moving higher in all maturities. How is this even possible? Blame (or as the companies do, credit) the yield curve with short-term rates higher than long-term rates companies with high cash balances can through prudent capital spending receive higher interest revenues by investing their money in short-dated notes, while their longer-term borrowing which locked in lower interest costs yields them a net positive flow. For many companies, net interest expense as a percentage of net profit is lower today than it was 20 years ago. This also explains why Fed rate hikes haven’t slowed the economy as much as it might have 40 years ago.

Currently, the US 10-year Treasury yield is higher than any other developed market yield with the exceptions of Italy and New Zealand. This has put a bid behind the US dollar. The greenback is up 6% in three months versus a basket of developed market currencies. Since trees don’t grow to the sky, the US dollar will at some point come back to earth and when it does non-dollar stocks will have more attractive US-dollar based returns for dollar-based investors. That makes this is an excellent time for U.S. based stock investors to increase their allocation to non-dollar markets. Prices are attractive. The Eurozone and Japan are trading at attractive discounts to U.S. stocks. And as the U.S. dollar, following 14 years of strengthening, finally gives up ground to the euro and the yen dollar-based investors will find themselves rewarded.

There is never a straight line to success, so keep in mind, ECB is lowering its forecasts for growth in that region while the Fed is raising its projections for US growth. As mentioned above Japan looks attractive. Oil is still a wild card as Saudi Arabia’s recent unilateral move to reduce oil exports has driven the oil price to $100. The Chinese economy has not responded to the end of COVID lockdowns as the government would have wanted. The authorities recently eased monetary conditions and will do what they need to do in order to get the Chinese economy running as they need it to. Europe depends on China more than the US ever has. China’s alignment with Russia will benefit defense companies as will the continuation of the war in Ukraine. U.S. companies are less exposed to China than European companies are. But there are European and especially Asian companies which are very well positioned to exploit the areas of growth in China that the government is committed to supporting.

On September 29th euro area inflation dropped dramatically to 4.3%, which was the lowest level since October 2021! Imports to Europe will now face a carbon tax based on carbon emissions caused by manufacturing. As you read this you can be forgiven for thinking that this all seems to spell out “two steps forward and three steps backward.” Why should this quarter be any different from so many before it. There are two things to expect for sure: you should expect to see more volatility; and you can count on the Investment Team at Haven Global Partners to continue to practice our process in the faces of whatever the markets bring.

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