Rathbones
Look forward

Review of the week

11 April 2023

The world has changed

Money was easy to come by in the 2010s, for businesses, households and governments. With interest rates now much higher, hard decisions loom.

After years of easy money when venture capitalists threw money at every Next Big Thing, and virtually anyone could get a cheap loan to bridge the gaps between cash in and cash out or their wages and their desires, we now find ourselves in a new era.

Attention is turning to those who have borrowed too freely on too little collateral - whether that collateral is a business, a cashflow or a vibrant economy. The calculation lenders and shareholders are now making is whether the collateral is sound: is the cashflow enough to cover the interest payments, is the business profitable with a healthy future, is the nation growing and spending sustainably?

You can see this new fixation exerting itself in all markets. In past years, a loss-making start-up would be fed money for as long as it could convert the cash into new customers. Now investors have abruptly cut them off and demanded a dash to profit. A couple of years back, corporate bond investors swamped any bond sale to ensure they could lock in the best possible rate, to the point where deals often attracted much more cash than issuers were asking for - sometimes many times more. Today, companies must offer substantially higher yields to entice investors.

During the 2010s, cash was almost like a curse: 'value' companies - those that paid investors today rather than reinvesting for the future - were avoided like the plague. What would you do with that money that kept getting returned to you each year? Where could you invest it? Every year, the prospective rate of return you could get in the markets ground ever lower (measured by yields on bonds and equities). And then, in a little more than a year, global prospective rates of return surged many percentage points.

Nations will be the next frontier for this attention. When interest rates were low and, crucially, when inflation wasn't high, governments could run large deficits. Whether the protagonists realised it or not, talk of debt sustainability was more about political orthodoxy than it was about economics. Low rates and inflation also allowed governments to go big on support programmes for households and businesses when the pandemic struck. Now that prevailing interest rates are several times higher, the cost of servicing public debt is higher and will only increase as the years march on and old debts get refinanced. This will influence politics and through it the policies that will govern how we live, work and invest. Higher inflation may reduce the debt burden, but we expect inflation of roughly 2-4% each year over the coming decade, compared with the 1-3% of the 2010s - not high enough to make a huge difference. We do think inflation will be more volatile, however, and that is likely to constrain governments from running large deficits.

Some nations are now approaching potentially onerous levels of indebtedness, albeit it's hard to determine how much is too much, especially when prevailing interest rates have changed so dramatically. Despite its bad rap, debt isn't universally a bad thing. Without it, you wouldn't have been able to buy a house, your business would have less tools, technology and resources, and the state would be akin to John Hobbes' *Leviathan*.

Governments' borrowing to invest prudently increases the productivity and health of our societies, boosting wealth and economic endeavour, increasing tax receipts proportionately to help pay the tab. So, simplistically, it makes more sense to borrow money at 5% if you can invest it in railways, schools and hospitals that boost your economic output by 7% than it does to borrow money at 1% if you're just going to lose it to corruption or bad projects that will be lucky to break even.

The first concerns about unsustainable government debts always pop up in emerging nations, due to a combination of their currencies weakening as higher prevailing rates in safer developed bond markets suck investment away and a self-reinforcing belief about their inherent riskiness. A report by debt forgiveness lobby Debt Justice notes that low-income nations' repayments will rise to 16% of their tax revenues in 2023, the highest level in 25 years.

However, similar concerns are bubbling up for advanced economies as well. Finnish voters just voted out their government driven by concerns about the public debt-to-GDP ratio rising roughly 10 percentage points to 73%; the winning party advocated cuts to welfare and education and subsidies for businesses to reduce the debt. In France, people have reacted much differently, despite French debt-to-GDP being much higher at 110%. President Emmanuel Macron's decision to increase the retirement age from 62 to 64 to try make it more sustainable sparked protests and riots that have continued for a month.

The US also has a looming pension problem. According to the latest report from the Social Security (pension) and Medicare (retirees' free healthcare) trustees, the money is set to run out in about a decade. The fund for Medicare will dry up in 2031 and Social Security will be empty by 2033. These two policies cost about $2.2 trillion (8.6% of GDP) each year and rise inexorably. They need more cash but they butt up against the perennial problem of today's developed nations: rapidly ageing populations. There simply aren't enough workers to support retirements of so many people who are living much longer than anyone expected when the systems were put in place in the 20th century. America has a debt-to-GDP ratio of almost 130%. The pension problem has been known for many years, but the political will to solve it has been absent. In a world of much higher interest rates, this may finally come to a head.

These sorts of difficult problems will be faced by all countries in the years to come and how they are solved - or not - will affect people and businesses and influence the choices they make.

Investing for tomorrow

We've been focused on debts for a while now. We're comfortable with developed world governments and don't expect them to go bankrupt anytime soon! Instead, we're trying to ensure that the businesses whose shares and bonds we own have reasonable levels of debt. That they aren't at risk of drowning under large and growing loan repayments. This isn't the only thing we look at, of course, but it is a big source of fragility in today's world. Since early February, companies with higher interest cover (profits divided by interest payments) have been outperforming peers with low interest cover. This factor did especially well in March when US banking turmoil raised the prospect of an even greater tightening in bank lending conditions.

We believe that US interest rates should peak next month; however, there's still a risk that they will go yet higher if inflation refuses to fall. Another 25-basis-point increase from the US Federal Reserve is expected next month, which would take the benchmark US interest rate to 5.25%. On Tuesday the US CPI inflation print for March is forecast to drop from 6% to 5.2%. If inflation doesn't fall as much as expected, it will boost expectations for yet more rate hikes and increase the squeeze on overindebted firms and households all around the world.

Economic data in many countries has been dipping lately as the effects of higher rates filter through into the real economy. We think this is likely to continue, with a mild global recession more likely than not this year.

Navigating mild recessions is a normal part of investing, so it shouldn't discourage people investing for their future. They rarely hold back equity returns for long, which is why we're staying invested. In the meantime, we're focused on companies with strong returns on their investments, easily manageable levels of debt and high profit margins that remain stable. We believe these businesses will be best able to navigate any coming turbulence and thrive in the world that comes after.

*If you want to hear more about the outlook for inflation and interest rates, recent banking sector wobbles, and get the first look at our new review of China, you can r*egister *for our 12 April Investment Insights webinar here*.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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