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MARKET INSIGHT – NO MORE FREE LUNCH

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With markets proving highly sensitive to monetary policy speculation, Roy Leckie, Executive Director – Investment and Client Service, considers the impact of today's higher interest rate environment and the merits of a conservative approach to debt financing.

After the euphoria of the closing weeks of 2023, equity markets have started this year in rather more laboured fashion. In truth, sustaining the galloping momentum that had pushed many equity indices to near-record highs was always going to prove challenging, fuelled as it was by a highly optimistic reading of Jerome Powell's December statement on interest rates.

More sober heads were already starting to prevail before the release of the minutes from the Federal Reserve's December meeting suggested that the market had indeed got ahead of itself. Whereas many investors had begun to price in a rate cut as early as March, a still-cautious Fed appears to favour holding fire until the summer.

ROY LECKIE
Executive Director –
Investment & Client Service

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The whole episode has been another reminder of the outsize influence of monetary policy speculation on today's market. Perhaps this shouldn't come as a surprise; we've written previously that exiting the ZIRP era was always likely to prove somewhat turbulent. Even so, recent shifts in sentiment have been extreme.

From our perspective, this obsessive crystal-ball gazing isn't just the very definition of short-termism, it also rather misses the point. Barring another inflationary spurt, rates look likely to fall in 2024, but over a long-term investment horizon does it matter whether the first cut comes in March or June? Does it matter whether we see three cuts or four in the next twelve months? Not particularly.

It is enough to know that the cost of capital has risen and, wherever the neutral rate of interest rate might lie, the market's comfort blanket of ultra-low borrowing costs has been taken away for the foreseeable future. This has implications for those of us investing client capital in search of sustainable, long-term investment returns.

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One of the defining features of more than a decade of cheap money was the ability of callow companies with disruptive business models to pursue debt-funded growth strategies with scant regard for inconvenient mundanities such as turning a profit. Investors happily played along, turning a blind eye to a lack of profitability as long as the businesses in question were growing. Borrow heavily, grow fast, take share was the playbook. Some companies made hay, many more less so. A prolonged period of higher rates suggests this particular route to success has now run out of road.

But it wasn't just brash newcomers who gorged on cheap money. Many established companies also enthusiastically took advantage, some excessively so, tapping debt markets not only to fund growth but also to finance ambitious shareholder return policies. Again, today's cost of money asks questions of such an approach. Debt refinancing at higher rates will crimp profitability, trim capital expenditure and impose limits on the largesse shown to shareholders.

To be clear, we're not predicting that a debt cataclysm lies just around the corner; the majority of non-financial corporate debt is on fixed terms and is well spread by maturity. But even where manageable, those companies running with high levels of leverage will have their future ambitions pruned to some degree.

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It's a reminder of why Walter Scott has always paid great attention to corporate balance sheets and debt levels. Our preference is for companies with no or low levels of leverage, companies whose high levels of profitability and cash generation enable them to finance growth internally rather than rely excessively on the kindness of strangers. Endowed with greater control of their destiny, such companies are better placed to invest for the future and weather the inevitable macroeconomic headwinds.

Looking across our portfolios, debt levels are significantly lower than those of their respective benchmarks. Perhaps during the era of zero interest rates such an approach appeared unduly conservative to some observers. That's unlikely to be the view today.

Before signing off, may I wish you all a happy and prosperous 2024. Last year's impressive equity market returns were a welcome surprise for many of us and whilst I'll refrain from making predictions for the year ahead, I will say that we remain very confident about the long-term prospects for our investee companies and hence our clients' portfolios.

There are, as always, reasons for caution, whether geopolitical or macroeconomic. With almost half the world heading to the polls, it's also sure to be a noisy year politically. Equally, there are some very real reasons for optimism and excitement. AI and GLP-1s immediately spring to mind and the Research team has been busy digging into the potential implications of these transformative technologies.

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But whatever the ultimate direction of markets in 2024, we'll be sticking with the philosophy and core principles that have stood us in good stead over the past 40 years. Confident but not complacent, we remain laser focused on researching, analysing and valuing great companies, buying and holding them, and letting compound growth do the rest.

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STOCK EXAMPLES

The information provided in this article relating to stock examples should not be considered a recommendation to buy or sell any particular security. Any examples discussed are given in the context of the theme being explored.

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM

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