Continuum Global Asset Management, LLC

Impact of Interest Rate Increase

The beauty of the so called professionals on Wall Street is that they have an uncanny ability to explain events on the street after they have already happened. Recently all major news sources have been filled with information and explanations as to why the capital markets reversed its rally mode during the week of June 4th. All stories turn to one explanation; an expectation of higher interest rates that can hurt the domestic economic growth and therefore detrimental to the capital markets.

Dow Jones Industrial index Feb 14th-June 15th

Figure 1[1]

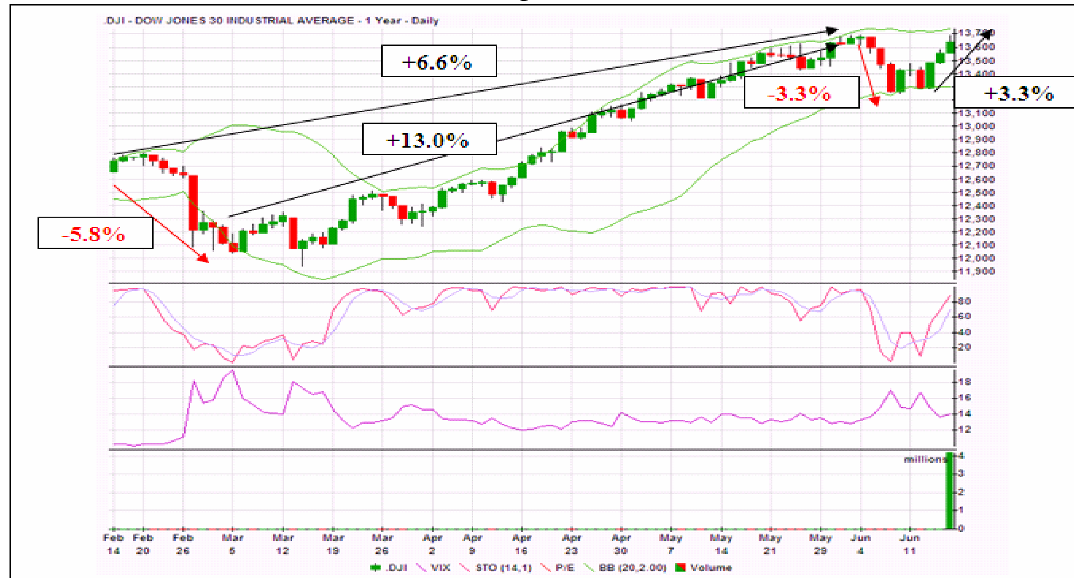

Figure 1 represents the Dow Jones Industrial Average Index's (DJ Index) movement since February 14th, 2007. It can be observed that the index lost approximately 6% and 3% during the week of February 20th and June 4th respectively. Another important observation is that the DJ Index has gained over 7% since the first drop of markets this year.

The market started this year with worries about high oil prices and declining housing market that could choke consumer spending hence decelerating GDP growth. In the midst of first quarter earnings, global appetite for trade and rising commodity prices the markets charged ahead unabated. The Chinese market which had gained over 100% in 2006 experienced a decline of 9% on February 27th. This triggered the first worldwide market decline in 2007. Within a few days the markets brushed this event off and stared making new highs.

[1] *Source: Fidelity.com*

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10 year Treasury yield…

A major development took place at the beginning of June. As shown in Figure 2, the 10 year Treasury (10 TSRY) yield rose from under 4.9% to 5.2% in less than two weeks. In other words the 10 TSRY yield, used as a measure for the cost of capital for major debt instruments like corporate debt and mortgages, increased 6% during this period.

Figure 2[2]

…impact on cost of capital

Also illustrated in Figure 2, the DJ Index reacted inversely to the increase in yields. This development indicates market expectations of a hawkish bias from the Federal Open Market Committee (FEDs). In other words the bond markets are expecting the FEDs to raise rates. This is a direct consequence of increasing world wide wages and higher commodity prices; an expectation of higher inflation. Recently, European Union, Bank of England and the Bank of Japan, all exhibited their bias to strategically raise rates.

Liquidity squeeze…

The International Monetary Fund has predicted global growth to increase at a rate of 4.4% for the year 2007-08. In addition to explosive growth in emerging regions like Asia, Eastern Europe and Latin America, low global interest rates have fueled liquidity further fueling growth due to low cost of capital. An expectation of this favorable interest rate environment turning unfavorable or squeezing liquidity could consequently decelerate global economic growth.

[2] *Source: Fidelity.com*

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Rates affecting GDP growth in the USA…

Even though US is not the only economic engine fueling the world, it is a major consumer and importer of goods and services from rest of the world. Any increase in cost of capital (rising rates) will put a damper on the GDP growth which has already started to show some deceleration.

To understand the impact of rate increase, following is a brief analysis reviewing an important facet of the US economy; corporate debt.

US Debt to Equity…

The US economy is approximately $12 trillion strong. Currently, the DJ Index has a total market capitalization (market value) of approximately $4.4 trillion[3], or 1/3rd of the total market capitalization of the US equities. The average debt to equity ratio of the companies in this index is 0.58, which translates to approximately $4.5 trillion dollars[4] of debt.

The market capitalization of the Wilshire 5000 index (a composite of over 5000 US companies) is approximately $13.4 trillion[5]. If the debt equity ratio calculated for the DJ Index is extrapolated to the Wilshire 5000 market capitalization, we can reasonably infer the US corporate debt to be approximately $7.8 trillion.

Table 1 illustrates the impact of rising rates with an assumption that the entire US corporate debt of $7.8 trillion was based on adjustable scale. In other words, as rates increased, corporations would have to pay higher interest payments accordingly.

Table 1[6]

Current Corporate Debt ($ bill)	Interest Rate (%)	Annual Interest ($ bill)	Interest Increase ($ bill)
$7,800.00	5.00%	$390.00	
	5.25%	$409.50	$39.00
	5.50%	$429.00	$58.50
	6.00%	$468.00	$97.50

…impact on GDP

Historically, the US GDP has grown at an average of 3% per annum and policy makers feel comfortable with this number provided inflation is contained. <u>US GDP growth will decelerate to 2.1% from approximately 3%, if rates (10 TSRY yield) moves to 6% from approximately 5.1% illustrated in Table 1 above.</u>

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[3] *Source: CGAM, LLC*
[4] *Note: Total debt for DJ Index companies may be overstated due to the debt evaluation of certain financial companies.*
[5] *Source: Wilshire Associates Inc.*
[6] *Source: CGAM, LLC*

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Important Caveats

It is important to note that over 50% of the domestic debt is owed by large US corporations. These entities have experienced rate fluctuations umpteen times in the past and have utilized effective hedges. As a matter of fact, most large companies refinanced their debt obligations with favorable terms (low fixed rates) during the recent low rate environment. In addition, Fed fund rates have averaged 5.9%[7] over the last twenty years during which period the economy has been able to grow at an average of 3%.

Inference

It can be inferred that the small to medium corporate activity can be impacted adversely if rates move higher than 6%. Also, the housing arena will feel a larger impact with increasing rates. This phenomenon will also hurt consumption as adjustable mortgages start to take a toll on homeowners who have been using their homes as a source to draw money and sustain consumption.

Realistically, the FEDs will be compelled to consider raising rates if the monetary policy in Europe and Asia drives the dollar down to unfavorable levels. I believe that the Feds are in a difficult position currently. The US economy seems to be decelerating, desiring lower rates, whereas the global growth is accelerating putting pressure on the dollar. In my opinion the Feds will keep the rates steady unless the economy experiences inflationary pressures over the next 2-3 quarters. It is also important to recognize that the European Union and the Bank of England may be closer to ending their hawkish stance on rates which may relieve pressure on the dollar and provide the Feds with some breathing room.

To summarize, the global interest rate environment may be on a tightening bias, but it is still a conducive environment for global trade and economic expansion. With the inclusion of over a billion new consumers in Asia, Latin America and the Eastern Europe we have been and continue to operate in a favorable economic environment with significant growth to follow. Despite the short term fluctuations in the capital markets we should reap rewards if we stay committed to the strategic allocation discipline and exposure to international markets.

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[7] *Source: CGAM, LLC*

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