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Adapting to an environment of higher interest rates

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The relentless rise in bond yields has been the main theme in markets over 2022 and 2023. Since the beginning of 2021, the nominal US 10-year government bond yield has risen from 1.5% to a peak just above 5% in October. The real yield, which is calculated by subtracting inflation expectations from nominal yields, has risen from -1.02% to around 2.5%. While these may seem like abstract figures, they hold significant real-world implications.

To put things into perspective, it is unusual for real yields to linger above 2.5% for an extended period. In fact, over the past two decades, they averaged above this threshold for less than 9% of the time. The period between 2003 to 2007 saw real yields hovering over 2%, but the tide turned with the Fed's bond purchases following the Global Financial Crisis, which drove yields below 0.5% from 2009 to 2020. In 2023, real yields have rebounded to around 2.5%.

There are three implications that investor needs to consider in a world of rising bond yields and high interest rates:

1 Rethinking capital allocation for companies

As the cost of capital escalates, companies need to reconsider their capital allocation strategies. The cost of marginal debt for firms has seen a significant uptick, with the average US investment grade and sub-investment grade (or "high yield") companies now funding themselves at around 6% and 9% interest rates, respectively. This stands in stark contrast to just three years ago when the figures stood at around 2% and 4%. The cost of equity for firms has also risen, even though it is not directly visible. Both the cost of equity and cost of debt play a pivotal role in determining a company's overall cost of capital, the benchmark companies use to determine whether a capital project is worth pursuing.

With a higher hurdle rate, fewer projects will look attractive, and companies may become more discerning when choosing which projects to invest in. This could inevitably lead to a slowdown in earnings and a shift away from high-risk, high-reward ventures in favour of more stable and predictable investments. Furthermore, companies may increasingly lean towards

returning more capital to shareholders through dividends and share buybacks, which can be a more efficient use of capital, typically providing returns in line with the cost of equity capital.

2 Investors to become more selective

Higher bond yields compel investors to take a more selective stance. The US 10-year government bonds now offers above 4% nominal yield and close to 2.5% real yield, making them enticing investments for many. As a result, investors will need to consider how much risk they want to take in their portfolio going forward. Over the past decade, low interest rates made owning equities and other risky assets a necessity, but the case looks less compelling now. These shifts in preferences often tend to take years to fully unfold.

The repercussions of higher bond yields also extend to the realm of equity valuations. Higher bond yields argue for lower equity valuations, all other things remaining unchanged. Higher rates diminish the value of future cash flows at the firms. As demand for equities decline, equity price multiples typically contract. However, such effects may take time to fully materialise.

3 Where yields go from here matters

While long-term real yields are currently sitting at the upper end of their historical ranges, uncertainty around whether they will continue to rise or potentially decline looms large. Our model tracking investor diversity suggests the possibility of a pullback in yields over the next 12 months. However, if yields break out higher, investors may become more uncomfortable with owning bonds, much like a trader who would short a stock as it makes a multi-year high.

I see the risks to bond yields as balanced. There are valid arguments for both real yields to break out to new highs and for yields to decline from their current levels. Persistent US budget deficit, the Fed continuing to reduce its holding of government bonds, and the upside momentum to bond yields are supportive of even higher bond yields in the near term. On the other hand, history suggests real yields are likely to decline if US growth significantly moderates as we expect from Q4. It is difficult to envisage the US maintaining the robust 4.9% GDP growth reported for Q3. Meanwhile, any escalation in geopolitical risks could trigger safe haven demand for US government bonds, lowering the yields on offer.

External factors can also sway the course of bond yields. In the second half of 2023, investors have increasingly demanded higher yields to hold US government bonds after the US Treasury surprised the market with new budget deficit estimates and ramped up bond issuances. Uncertainty over the demand/supply dynamics for US government bonds suggests bond yields may not fall significantly in the near term. However, over the next 6-12 months, long-dated bonds could prove attractive in an environment characterised by decelerating inflation, slowing economic growth, and a greater likelihood of the Fed opting for rate cuts.

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