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Capital Management Group

News

The Capital Cyclops

The ramifications of tighter credit conditions, and the critical role of near-term cash flow generation over future earnings projections.

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"The ancient Greeks had a single word to express the condition of being "without a road," when the way forward is not clear: aporia. It represents a moment pregnant with the arrival of something unlooked for"

Mathew B Crawford, The Upside Of Risk

- Have the rules of the investing game changed?
- We lived in a world with easy-to-access capital and low rates for a very long time. That environment has shifted; the mindset of every economic participant, in my opinion, now has to turn 180 degrees
- Have the rules of the investing game changed? That is the central question all of us as investors must grapple with
- If so, what should we have at the forefront of our checklists?

First, it means doubling down on the importance of valuations as a critical investing metric. Being lenient on valuations is no longer possible, especially for growth businesses. When you compete with risk-free rates of close to 5% pa the hurdle must be higher.

Second, we need to understand the ramifications of tighter credit on business finances, especially on the second and third-order effects of higher rates.

Third, the focus shifts to near-term (next one-to-three years) cashflow generation ahead of future earnings projections.

The effect of higher rates is already showing up in company reports. Battery maker LG Energy Solutions recently told shareholders that EV sales would slow next year due to higher rates. A luxury residential project in Seoul is having difficulty after failing to get an extension on US$344 million in bridging loans. Altice, the telco giant built by French-Israeli billionaire Patrick Drahi, has sold everything it owns as it struggles to service US$60 billion in debt. India's outsourcing industry, a bellwether for the health of global firms, shed more workers last quarter than in any comparable period in the past five years. The IMF notes borrowing by governments, companies, consumers, and financial firms across Asia is well above levels before the global financial crisis, lifting the risks of default.

When rates were low, the cost of capital for businesses was subdued. Naturally, you had to own assets with long-duration cash flows well into the future. Perceptions about growth in the future can't be tested that easily - assumptions are just based on people's imaginations. With a low discount rate, the present value of those future cash flows is amplified. But in today's world, we must look for cash flows that can be generated in the near-term, hopefully with a higher degree of certainty.

That means the portfolio must gravitate towards companies that can find cost savings, reduce working capital or cut capital expenditure, preferably using that cash generation to buy back shares and reduce debt.

Consider this year's frenzy for AI stocks and weight loss drug manufacturers. In a way, they are echoes of the low-rate era. Everyone's assumptions and predictions are of the impacts that might happen five, ten, or fifteen years into the future. In recent years, a similar story has played out for companies supplying the renewable energy industry. But as interest costs have risen, renewable energy industries might find it harder to raise the capital to continue to invest in what could often be unprofitable projects.

The ramifications of higher interest rates on the businesses will be substantial, not just the effect on household and mortgage holders. The viability of many projects will be in question. It's a chain reaction. In solar and wind projects, the equipment manufacturers that supply these projects are now feeling the pinch. For semiconductors, it's not only the chipmakers feeling the pressure but also their suppliers. In China, the bursting of the property bubble is having a follow-on effect on not just suppliers of steel and cement but even real estate agents, finding that they have commissions that still need to be paid.

In effect, you have to step back and change the aperture of your lens. That is the ramification of the rising cost of money. And the speed of that rise has yet to hit us.

Above all, caution is the byword. As credit tightens, growth slows, businesses fail, and unemployment rises, many analysts expect central banks and governments to return to their old ways – cut interest rates and inject liquidity. There are bond bulls who think that a slowdown or recession will mean central banks will have to moderate their stance on raising rates, and therefore, we are close to the peak of the interest rate cycle.

But if the rules of the game have changed, we really must question even that assumption of central banks injecting liquidity. In my view, the Federal Reserve and other central banks, with their ultra-loose monetary policy, exacerbated our problems with inflation. If you were in their shoes, faced with an economic downturn yet lingering inflation pressures, would you take the same path you did during COVID?
Or would you think of 'Aporia'?

Source: JOHCM/Bloomberg

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