Institutional Insights

The rising cost of capital and its investment implications

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KEY TAKEAWAYS

- The past era of extraordinary monetary policy, including ultralow interest rates and extensive quantitative easing,[1] counterproductively created a disinflationary impulse that weakened bank lending incentives, reduced spending, rewarded financial engineering, and allowed for the misallocation of capital.
- Following the dramatic fiscal response to COVID-19, central banks have been challenged to unwind these policies and tame inflation. The Fed's focus on demand-side policies has been overwhelmed by supply-side effects.
- If this structural backdrop persists, we expect higher real (inflation-adjusted) rates over the next 5–10 years.
- Higher real rates increase the cost of capital, which we believe will engender a different economic and investment landscape that incentivizes lending, reduces savings rates, encourages retirements, and allows for a more efficient allocation of capital.
- Follow-on effects of a rising cost of capital include diminished profit margins and the culling of unproductive, debt-laden firms.
- Expected investment implications include a smaller performance advantage for equities compared with fixed income, better relative performance by large companies with high quality earnings generation, and greater opportunities to earn excess returns through equity and fixed income security selection.

Executive summary

In 2016, we warned in the AART Thought Leadership paper "Potential pitfalls of negative policy rates" that the era of quantitative easing and zero policy rates likely would result in unintended negative outcomes, including higher savings rates, less bank lending and lower productivity—each of which we've experienced in recent years. Similarly, in 2020, we argued in the paper "Unsustainable global debt: Roadmap for strategic asset allocation," that global debt spending is fast becoming one of the most substantial risks in the investing world, curtailing future growth prospects compared with recent decades.

Fidelity INVESTMENTS

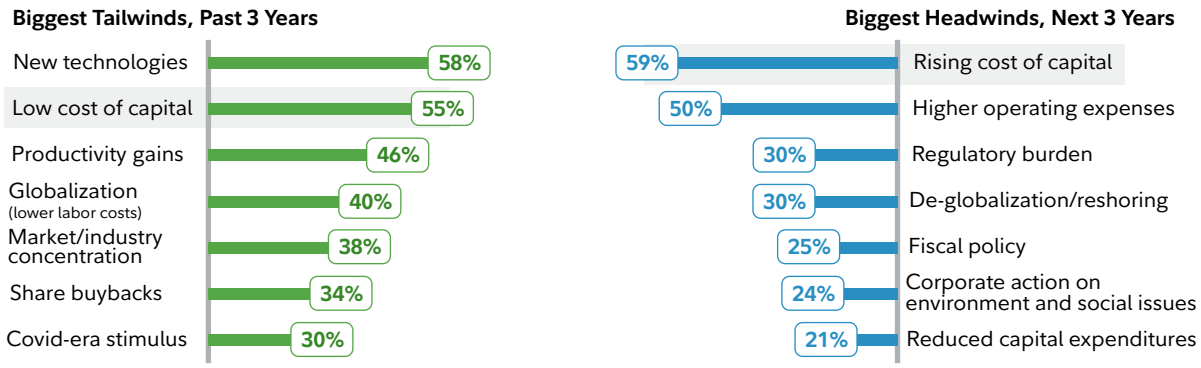
Today, we see the potential for additional unintended consequences from the unwinding of accommodative policies. The COVID-19 shock and the coordinated fiscal and monetary response that set off an inflation surge will not be easily cured. In fact, supply-related constraints may dampen the initial impact of rising policy rates, exacerbating inflationary impulses and pushing real rates higher into the next economic cycle.

Higher real rates correspond with a higher cost of capital, which is the hurdle rate for taking on new investments, such as a business expansion or acquisition. A higher cost of capital may limit growth opportunities for less-established companies and favor the prospects of quality earners with a high return on investment.

The rising cost of capital was cited in our 2023 institutional investor survey as the biggest headwind for corporate profits (Exhibit 1).

EXHIBIT 1: Institutional investors identify rising cost of capital as the biggest headwind to corporate profits.

Fidelity 2023 Institutional Survey, Questions on Corporate Profits



Institutional investor survey answers from the following questions: "Which of the following do you view as the biggest tailwinds for corporate profits over the past several years?" and "Which of the following do you expect to be the biggest headwinds for corporate profits over the next three years?" Bars in the exhibit represent the percentage of the top three responses. Source: Fidelity Institutional study of 500 U.S. institutional investors with at least $200 million in assets under management. Study conducted in May and June 2023.

Low and negative policy rates over the past decade inhibited lending, incentivized saving, encouraged financial engineering, and allowed the misallocation of capital. The unwinding of these highly accommodative central bank policies may counterintuitively stimulate inflation, incentivize lending, reduce savings, and discourage new corporate entrants—potentially for the next five years or longer.

The ramifications of the rising cost of capital may include:

- Higher policy rates throughout the next economic cycle that is likely to favor incumbents, or companies with established brands that generate high free cash flow
- The culling of many unprofitable, debt-laden firms
- Reduced competition and less business formation
- A wave of consolidation benefiting firms with quality earnings and free cash flow generation
- Pricing power in well-established firms within particular industries
- Surprising resilience in supply-constrained sectors including housing

How we got here

In the years following the Global Financial Crisis (GFC) of 2007–2009, global central banks used ultralow interest rates and the injection of trillions of dollars of liquidity into fixed income markets to stimulate growth and avoid systemic disruption. These policies helped support asset prices and avoid economic catastrophe.

In some cases, capital markets responded to these policies in unforeseen ways, including extremely low inflation.

The U.S. consumer price index, less food and energy, remained below 2.5% from 2008 to 2020, far below the average of 4% since 1970.*

Monetary stimulus boosted the prices of equities and other risk assets by suppressing risk premiums and discount rates. Following the 2008/2009 market nadir, stock valuations rose meaningfully amid historically low volatility.

Then, beginning in early 2020, the U.S. Federal Reserve and other central banks once again adopted extraordinarily stimulative monetary policies to resuscitate financial markets and the economy following the economic shock caused by the COVID-19 pandemic. In addition, a multi-trillion-dollar fiscal impulse from the U.S. injected massive amounts of money into the real economy.

This dual-policy response led to a sharp surge in asset values and propelled U.S. household net worth. Extraordinary fiscal stimulus into the household and corporate sector helped to reduce economic volatility. Extraordinary monetary policy incentivized corporations and mortgage holders to extend the term of their liabilities at super-low interest rates and encouraged companies to repurchase trillions of their own stock.

The unintended consequences of extraordinary monetary policy: Past vs. present

The following points summarize the unintended consequences of negative rates and extraordinary stimulus:

Equity valuations	↑	Suppressed risk premiums increased valuations.
Financial engineering	↑	Leverage, buybacks and the number of unprofitable public companies increased.
Bank lending	↓	Weak net interest margins pressured loan issuance.
Savings rates	↑	Older demographic cohorts delayed retirement or maintained low spending rates in the face of extraordinarily low fixed income yields.
Competition	↑	Low rates subsidized low-productivity ventures.

The following points summarize the unintended implications of cyclically higher interest rates:

Equity valuations	↓	Potential for higher risk premiums, lower valuations.
Financial engineering	↓	Less leverage used to fund unprofitable companies and stock buybacks.
Bank lending	↑	Bank profit margins no longer suffer under the burden of ultralow policy rates.
Savings rates	↓	Older cohorts save less and retire at historic rates.
Competition	↓	Higher rates cause low-productivity businesses to fail.

Why rates could stay elevated

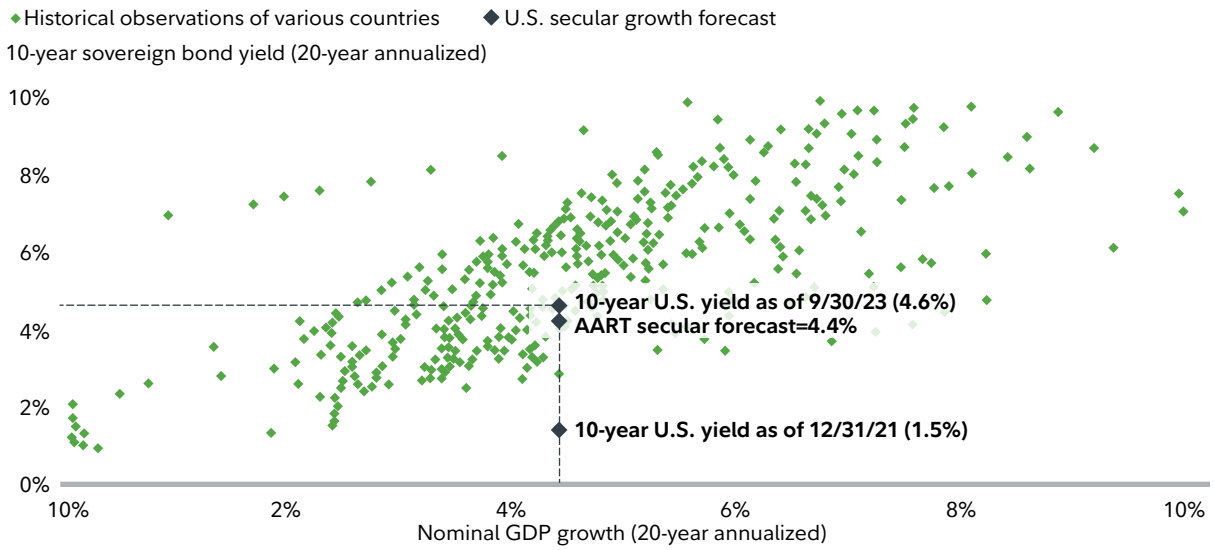
The unwinding of the era of ultralow rates is ongoing, potentially exacerbating market supply constraints in some sectors. For example, higher mortgage rates have constricted housing construction and reduced the supply of existing home sales. The resulting low supply of available residential units for sale—coupled with a strong labor market—generates upward pressure on shelter inflation. The low supply of labor and housing makes it more difficult for the U.S. Federal Reserve and other central banks to counteract inflation with its normal tools that seek to weaken economic demand.

If these supply/demand imbalances continue, we expect nominal rates likely will remain elevated in the coming years. Also, real rates likely will settle at higher levels as higher inflation limits central banks' ability to engage in the highly accommodative financial repressive policies that suppressed real rates over the last 15 years. A combination of other factors including deglobalization, aging demographics, and low productivity rates may also pressure the secular inflation backdrop and keep nominal and real rates elevated.

Over the next decade, we believe 10-year Treasury yields are likely to converge toward our nominal GDP forecast of 4.4% annually (Exhibit 2), which is derived from our secular U.S. real GDP forecast of 1.7% plus an estimated 2.7% inflation. Our 10-year Treasury yield estimate is based on the strong relationship between bond yields and nominal GDP growth rates over longer-term periods. Over the near-term, an economic contraction may help to push bond yields lower. However, we believe the persistent inflation factors are unlikely to dissipate, and would therefore keep borrowing rates higher, on average, compared with the last two decades. As a result, the prospects for reasonable risk adjusted returns from fixed income markets may have improved substantially.

EXHIBIT 2: We believe nominal Treasury yields will converge toward our long-term nominal GDP forecast.

Nominal GDP Growth vs. Sovereign Bond Yields (1985–2023)



Highlighted dots are U.S. 10-year Treasury bond yields. AART secular forecast refers to an estimate for U.S. nominal GDP (4.4%).
Source: Official Country Estimates, Haver Analytics, Fidelity Investments (AART), as of 9/30/23.

The impact of higher cost of capital

Higher interest rates will likely have a material impact on the consumer, housing, banking, and corporate sectors.

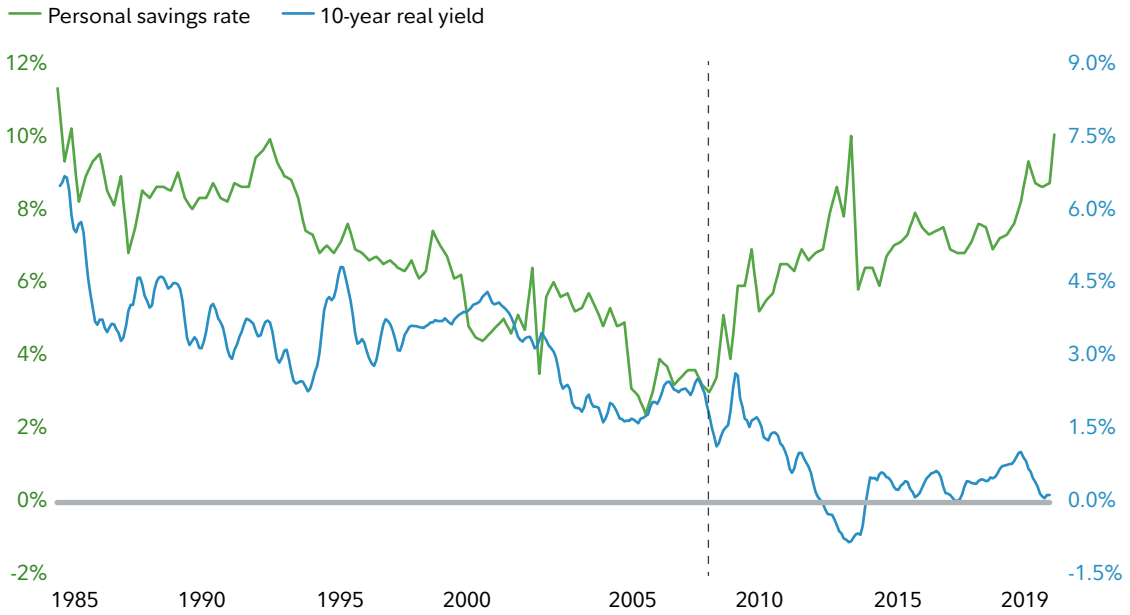
Consumer Sector: Aging demographics upend the historical impact of interest rates on savings behavior and put upward pressure on real rates.

We believe a rise in real rates will counterintuitively lead to higher spending and lower savings. Although higher real yields historically corresponded with higher savings rates, this relationship broke down around 2008 when the Fed pushed real rates negative, and savings rates ultimately trended higher (Exhibit 3). Going forward, we believe higher real rates will be a drag on savings in the following manner:

- Aging demographics and the recent post-COVID-19 wave of retirements will likely lead to lower savings rates and higher spending as older cohorts represent a larger share of consumers.
- The growing retiree cohort may need less precautionary savings, helped by higher yields on fixed income securities.
- Many middle-income retirees may see little degradation of their discretionary spending, as higher inflation rates boost cost-of-living adjustments for social safety net programs.

EXHIBIT 3: The relationship between real rates and savings rates has shifted.

U.S. Consumer Savings Rate vs. 10-Year Real Yields

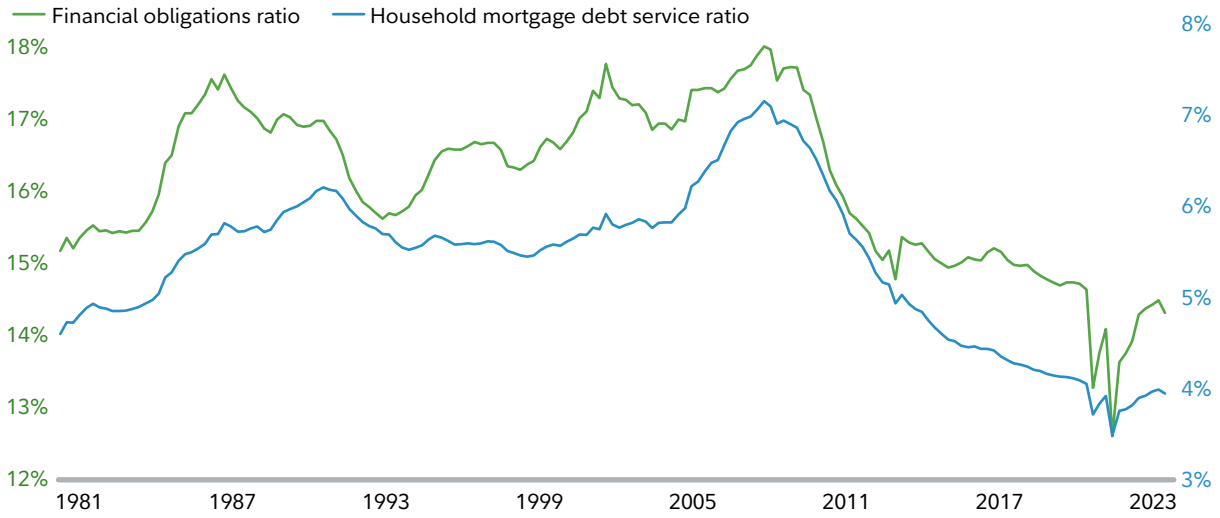


Dashed line indicates the beginning of the Fed's zero interest rate policy. Sources: Bureau of Economic Analysis, Haver Analytics, Fidelity Investments (AART) as of 12/31/19.

The household sector's debt service burden (the share of interest-related payments relative to income) currently hovers near an all-time low of around 15% (Exhibit 4). Despite the sharp increase in rates over the past year, consumers have yet to feel significant pain, especially for existing homeowners locked into extremely low mortgage rates, which has helped keep mortgage debt service at just 4% of U.S. disposable income, on average.*

EXHIBIT 4: Higher policy rates have yet to meaningfully impact consumers' debt service costs.

U.S. Consumer's Interest Rate Obligations



Household Mortgage Debt Service Ratio shown above corresponds to the mortgage debt as a share of disposable income. Financial obligations ratio: automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance and property tax payments relative to disposable personal income. Source: Federal Reserve, Macrobond, Fidelity Investments (AART) as of 4/1/23.

The combination of low mortgage rates on existing homes and a shortage of housing supply blunts the impact of tighter monetary policy. If weak supply continues to put upward pressure on housing prices, policy rates will need to be held higher for longer to dampen shelter inflation, which has been running above trend in recent years.* Higher real yields increase real coupon income on fixed income securities while increasing corporate interest expense, reducing profit margins, and lowering return on equity. This narrowing gap between stocks and bonds is consistent with the Asset Allocation Research team's capital market assumptions.

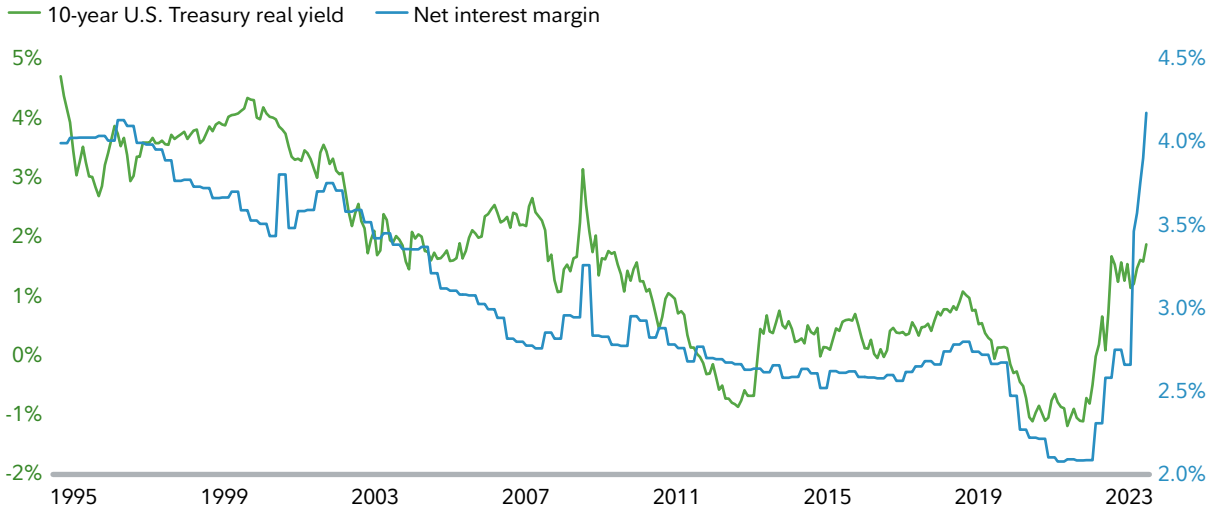
Key investment implication: A potentially smaller performance advantage for equities compared with fixed income.

Banking sector: Banks' greater willingness to lend over the next cycle supports inflation

Although lending activity has been weak in 2023, we believe a higher cost of capital environment may be favorable for bank lending over the next business cycle. Higher real rates benefit bank profitability through higher net interest margins, which increases banks' willingness to lend (Exhibit 5). A higher rate of bank lending increases money supply through greater money velocity, providing a greater inflationary impulse. An inflationary backdrop reduces the risk of credit/debt instruments as borrowers can inflate their debt away.[2]

EXHIBIT 5: Higher real rates correspond with higher bank margins.

Net Interest Margin of U.S. Commercial Banks vs. 10-Year Real Yields



Net Interest Margin measured by U.S. commercial bank earnings as a share of interest-earning assets. Source: Federal Reserve Bank of New York, Haver Analytics, Fidelity Investments (AART) as of 8/31/23.

Key investment implication: Assets with credit exposure—including corporate bonds and private credit—provide higher real coupon income and benefit from inflation eroding away balance sheet debt.

Corporate Sector: We expect incumbent business models will thrive over the next 5–10 years.

In the corporate sector, a higher cost of capital generally makes it pricier for new businesses to form, thus reducing economic competitiveness. This favors companies with quality earnings and positive free cash flow generation. Higher costs for inputs and interest expense tend to put downward pressure on profit margins unless companies can pass along higher costs to end consumers and/or improve efficiencies through productive investment.

We believe a higher interest-rate environment would favor incumbents, or the established, large cap high free-cash-flow-earning companies with a strong brand presence. Many of these incumbents would benefit from decreased competition and a slower pace of corporate entrants.

Conversely, nonproductive companies that have survived long periods with negative earnings and relied on capital raises to fund operations may fare poorly if higher borrowing costs persist in the next cycle. This could negatively impact the private equity sector, in which cheap capital allowed non-profitable businesses to survive in the hopes of being acquired.

Removing nonproductive companies from the economy is healthy and eventually boosts productivity, although this process could take place over years. Companies that are moving the needle with either promising new technologies or inventions that mitigate wasteful externalities may ultimately lead to higher rates of productivity growth. This could include certain companies in the industrials and technology sectors that compete with more established producers. It may also include certain energy, utilities, and materials companies that could be at the heart of the technical transformation associated with the climate transition. See 2023 paper, "A Strategic Allocator's guide to productivity and profits" for additional insights related to productivity growth and expectations for corporate profits.

A Strategic Allocator's guide to productivity and profits (summary)

In mid-2023, we concluded that the global economy and the backdrop for financial markets have transitioned to a more volatile world in which persistent inflation uncertainty will likely make some key investment drivers of the prior regime—such as financial repression and increasing leverage—less effective.

Rising costs, including higher interest costs, may boost the incentive for companies to raise capital expenditures—the opposite of the disincentive toward corporate savings behind the investment trend the past 10 years. In this new environment, the backdrop for global asset performance is likely to reattach to core fundamentals, such as productivity gains.

Understanding the drivers of productivity—and their links to profits and asset-class returns—could hold the key to successful strategic asset allocation.

Impacts may include:

- Greater investment spending in many developed and some emerging markets
- Lower equity correlations across regions and countries
- Greater opportunities through active management and thematic portfolios

Yet they may also include:

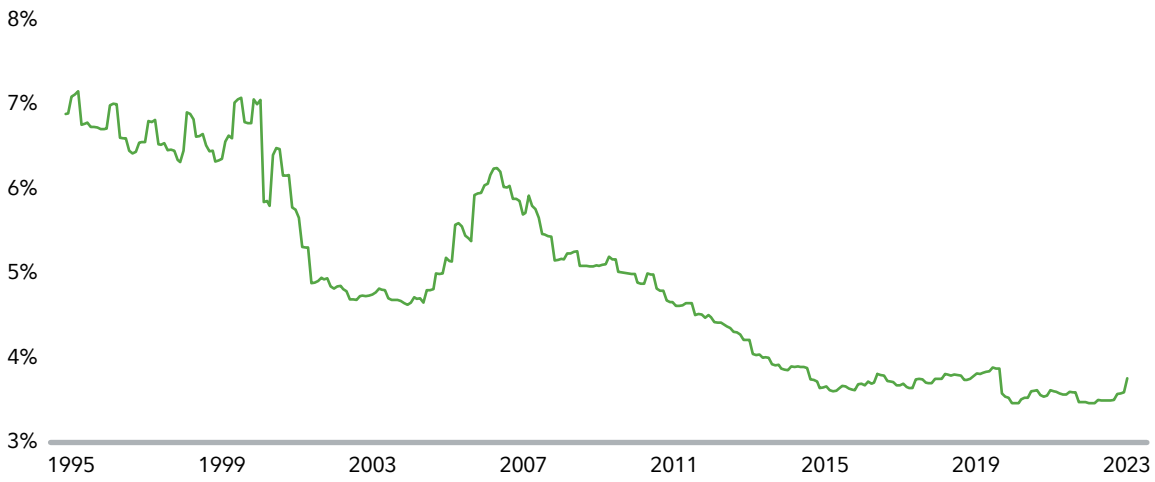
- Higher and more volatile inflation
- Higher asset-price volatility

As a result, asset allocators face a different set of opportunities and risks than in past decades. This could require more nuanced diversification and nimbler investment strategies.

Much like the lagged impacts of higher policy rates within the consumer sector, we also believe the corporate sector may prove to be resilient to higher interest rates. Despite a sharp rise in policy rates, interest expense as a percentage of total debt among S&P 500 companies remains at its lowest level in nearly 30 years (Exhibit 6). The coupon rate paid by non-financial companies on their existing debt load remains around 4%, well below the average of the past several decades.

EXHIBIT 6: Despite higher policy rates, interest expenses of large companies remains low.

S&P 500 Interest Expense as a Percent of Total Debt



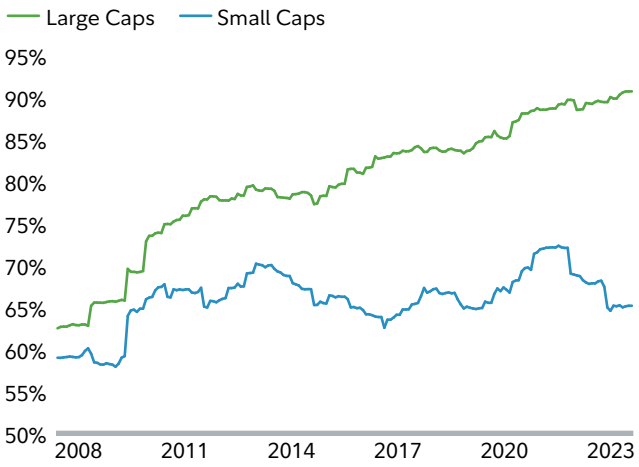
Sources: Factset, Fidelity Investments (AART) as of 8/31/23.

The lagged impact from higher rates can be attributed to companies taking advantage of extremely low borrowing rates during 2021 to "term out" their debt, effectively locking in low rates for longer. Even amid a rising trend for long-term debt as a percentage of total assets, 90% of large cap debt is fixed-rate, and a large share of it matures in 2025 and beyond (Exhibit 7). Many of these companies may not see significant interest-coverage changes in the coming years. Small cap companies are less resilient to higher rates. This is because they have about a third of their debt in floating-rate debt securities and a higher concentration of debt maturities over the next three to six years, making them relatively more exposed to higher cost of capital (Exhibits 7 and 8).

We dug deeper into this trend to see how long companies can handle higher borrowing rates. We looked at publicly traded company balance sheets and stress tested their interest coverage ratios (EBIT relative to interest expense), over the next five years. Our analysis suggests most public companies will be able to maintain strong interest coverage and, therefore, be able to navigate well through a rising rate environment (Exhibit 9).

EXHIBIT 7: Large cap companies are less rate-sensitive than their smaller counterparts.

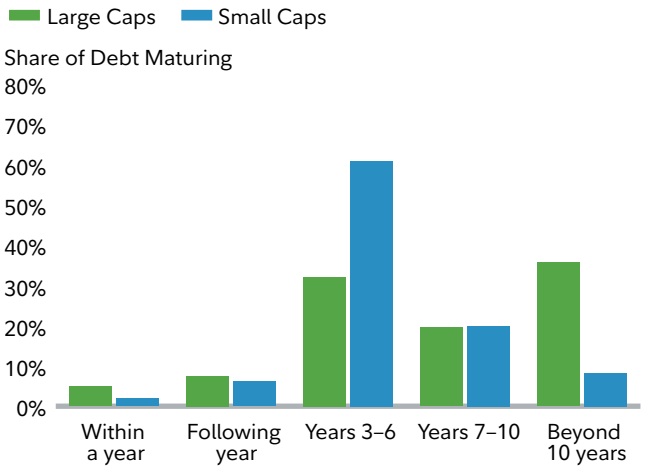
Share of Fixed-Rate Debt: Large Cap vs. Small Cap Stocks



Excludes financial and real estate stocks. Source: Empirical Research Partners Analysis, Fidelity Investments (AART) as of 8/31/23.

EXHIBIT 8: Larger companies have less debt than smaller companies to re-finance over the next few years.

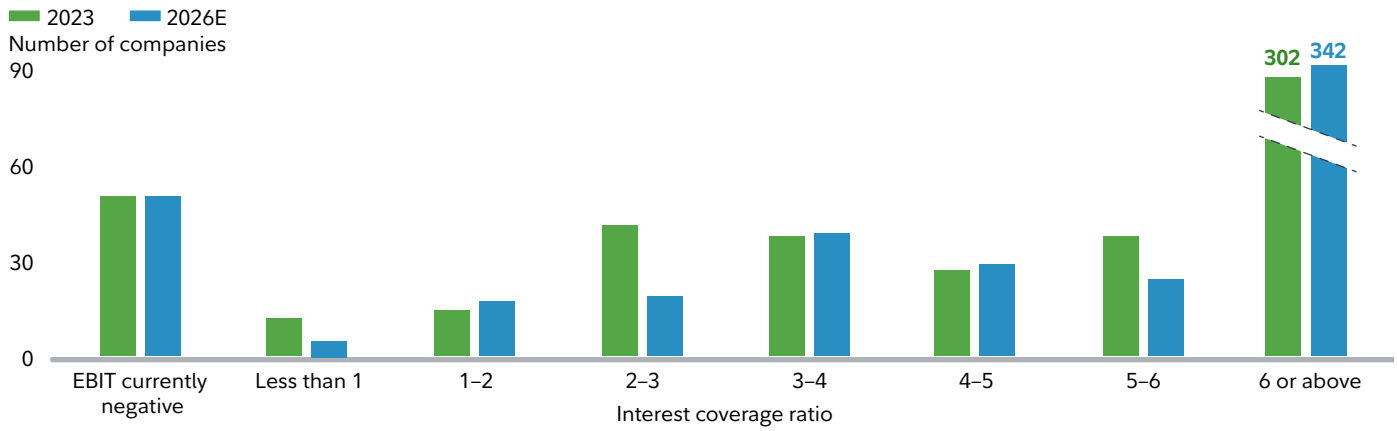
Large and Small Cap Stocks' Debt by Maturity



Excludes financial and real estate stocks. Source: Empirical Research Partners Analysis, Fidelity Investments (AART) as of 8/31/23.

EXHIBIT 9: Most large publicly traded companies will not be significantly impacted by a rising-rate environment.

Large Cap Company Interest Coverage Ratios



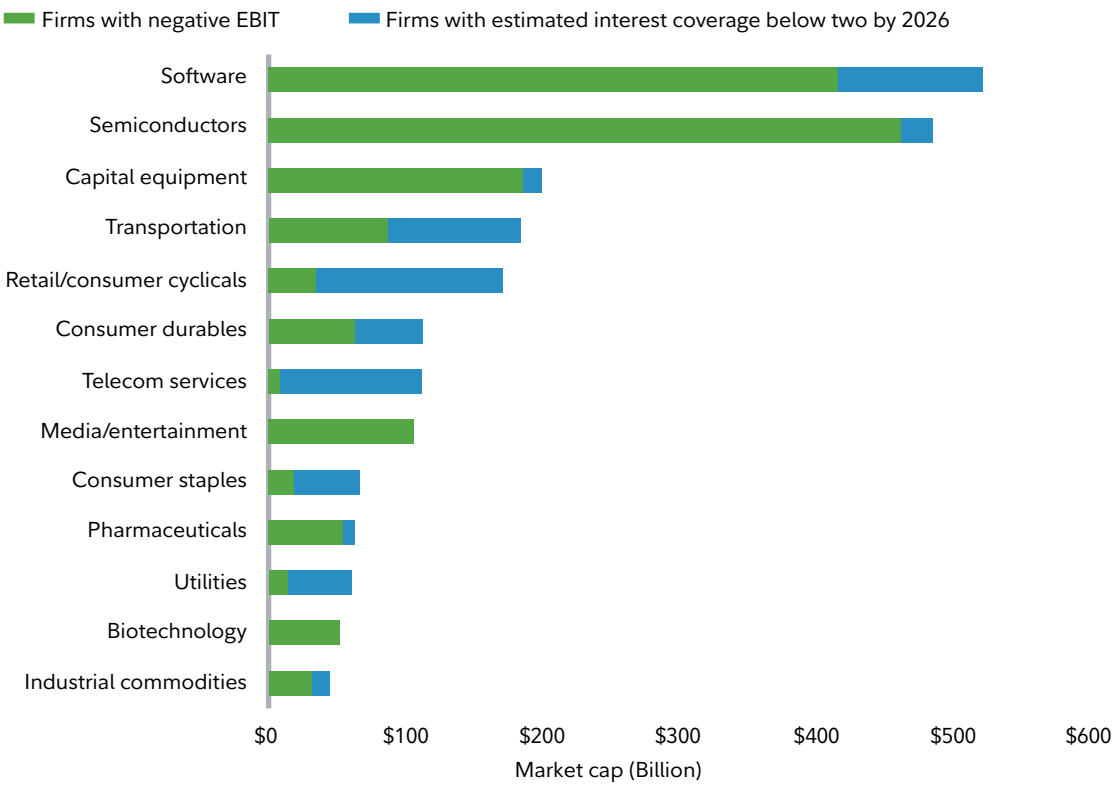
Large cap stocks are composed of a list of 750 publicly traded U.S. stocks excluding the financial and real estate sectors. Interest Coverage Ratio is a share of Earnings Before Interest and Taxes over Interest Expense. Analysis estimates trajectory of interest coverage based on current debt maturity profile, assuming a rising cost of capital, and an earnings projection contingent on prior high inflationary periods. Excludes financial and real estate stocks. Source: Empirical Research Partners Analysis, Fidelity Investments (AART) as of 8/31/23.

Conversely, an increasing number of less-established companies with less quality earnings and shorter-term and variable rate debt may need to refinance debt at higher rates over the next one to two years. This will have a material impact on "zombie" companies that currently generate either negative earnings or earnings below their interest expense. Lenders will be more selective in a higher-rate environment, which makes it more challenging for lower-quality companies to keep their businesses operating.

To see where the vulnerabilities may exist, we performed a similar analysis on interest coverage, looking at how different industries would fare under a rising rate environment. The two industries that flagged as most rate sensitive were in the technology sector (Exhibit 10). This does not suggest these sectors are in trouble. Rather, we interpret the findings to support our thesis that many of the nonproductive, unprofitable companies that could survive in a low-rate environment are in the fast-growing tech sector.

EXHIBIT 10: Non-profitable technology companies with low earnings and high debt may be challenged under a higher interest rate environment.

Industry Breakdown of Large Cap Companies with Low Interest Coverage



Interest Coverage Ratio is a share of Earnings Before Interest and Taxes over Interest Expense. Analysis estimates trajectory of interest coverage based on current debt maturity profile, assuming a rising cost of capital, and an earnings projection contingent on prior high inflationary periods. Excludes financial and real estate stocks. Source: Empirical Research Partners Analysis, Fidelity Investments (AART) as of 8/31/23.

Going forward, a subset of these companies likely will be exposed to higher borrowing rates, challenging their ability to survive. Whereas highly accommodative monetary policy made security selection more difficult, the next 5–10 years just may prove rewarding for active management under a new regime of higher borrowing rates.

Key investment implication: A higher cost of capital benefits larger, already-established companies with high quality earnings and pricing power. Companies with negative free cash flow and high debt may struggle. Security selection in both equity and credit markets will be a key component to improving investor returns.

Conclusion: The need for nimbler strategies

Our prior papers on the unintended consequences of extraordinary monetary policy highlighted that ultra-low/negative policy rates would create deflationary dynamics. Today, we believe that a higher cost of capital may keep inflation robust as the impact on supply-side factors are surprisingly large relative to the impact of higher rates on demand destruction. This environment will likely reward the incumbents, which include consumers and corporates with strong balance sheets and quality income streams.

Overall, we believe a higher cost of capital will have the following investment implications:

- An expected smaller performance advantage for equities relative to fixed income securities, compared with the last two decades.
- Greater security selection opportunities for equity and fixed income investors focused on high quality of earnings and positive free cash flow generation.

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Jacob leads a team that conducts economic, fundamental, and quantitative analyses focused on macroeconomic policy and financial-market trends as part of the broader Asset Allocation Research Team (AART). These analyses help Fidelity's portfolio managers and investment teams develop asset-allocation recommendations.

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Fidelity Research Associate Azize Engin contributed to this report. Fidelity Thought Leadership Vice President Michael Tarsala provided editorial direction for this article.

Endnotes:

* Source: U.S. Bureau of Economic Analysis

[1] Quantitative easing refers to monetary policy that involves a central bank, such as the U.S Federal Reserve, purchasing securities from the open market.

[2] Inflating away debt is a term referring to the impact of inflation reducing the real (inflation-adjusted) value of debt over time.

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Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rates rise, bond prices usually fall, and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments.

Additionally, bonds and short-term investments entail greater inflation risk—or the risk that the return of an investment will not keep up with increases in the prices of goods and services—than stocks. Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

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