As the third quarter came to a close, interest rates began to rise. The Fed raised the Fed Funds rate on September 26 and subsequently added a bit of hawkish commentary. That, combined with solid economic data, led to a sharp move higher in rates in the final days of September and early days of October. Prior to this move, treasuries flirted with higher rates during the third week in May. The 10-year treasury closed at 3.11% then, but moved lower as the U.S. dollar surged and emerging markets began to weaken. The 10-year traded above 3.11% intraday on September 25 and closed above that level at 3.18% on October 3, 2018. By October 5, the press raised the alarm, “U.S. Government 10-Year Notes Yields Climb to Seven-Year High” was the Wall Street Journal’s headline followed by, “Strong economic data reduce the demand for safety of Treasurys” as a subtitle. We say Bravo!

We have been calling for the normalization of interest rates since 2013 when we wrote a commentary criticizing the economic distortions rate subsidies could thrust on the economy. In that commentary we wrote, “We believe the U.S. economy is robust enough to stand on its own. Despite the severity of the recession, the Fed’s actions may now be creating more distortions than producing the Fed-mandated results. The longer the Fed maintains its interest rate subsidies, the harder the withdrawal will become. For now, a move higher in interest rates to a level that is still low by historical measures, seems like a reasonable market reaction. As more markets get distorted by subsidized rates, more unexpected reactions will accompany the eventual withdrawal. The Fed should avoid making unprecedented policy actions a standard part of its arsenal.” On December 31, 2013, the 10-year treasury closed at 3.03% while the long bond reached 3.97%, both the highest levels of the year.

Observers may applaud the Fed’s restraint in late 2013 as subsequent external factors, including a war between Russia and Ukraine, the collapse in oil prices and a deep crisis in the European periphery held back global growth. In hindsight, the U.S. economy was recovering in 2013, but perhaps not robustly enough to carry the world. Now, improvements in global growth are more reliably led by the robust U.S. economy. Citing our 2013 letter, “…a move higher in interest rates to a level that is still low by historical measures, seems like a reasonable market reaction.” In this respect, we commend the Fed’s more aggressive posture and the move higher in rates, not because we like high rates, but because we would like to see entirely market determined rates along the yield curve. As we noted before, absent the extraordinary policy measures that gave us inordinately low interest rates for years, investors would be astonished by a 3.2% 10-year treasury in an economy with 3+% real growth, a 3.7% unemployment rate and a 2.3% inflation rate.

Evidence of damage wrought on people, assets and businesses as a consequence of enduring uneconomic subsidies abounds. In New York, everyone criticizes the condition of rent-stabilized apartments, in Venezuela, the oil sector has deteriorated steadily due to underinvestment, in economies with socialized/subsidized medicine, patients form lines for treatment, and in subsidized rate economies, asset valuations can get highly distorted. After 2008’s financial market debacle, most defined benefit pension plans in the U.S. became woefully underfunded. While many analysts pointed to the decline in asset prices as the culprit, the more consequential source of the problem was the extreme reduction in interest rates used to calculate the value of each pension fund’s obligations. For nearly a decade, state, municipal and even corporate plans have been forced to calculate the value of their obligations to beneficiaries using excessively low rates. This has led many pension officials to divert resources for plan replenishment, take more investment risk to reach assumed rates of return or cut benefit payments.

In another example, corporations issued record amounts of debt in the public markets for 6 consecutive years. Analysts and the media frequently fret about the coming reckoning after illustrating their commentary with debt growth graphs. We often wonder whether writers see the logic for corporate treasuries to avail themselves of inexpensive debt when rates are being effectively subsidized by the central bank. Surely, in deciding to pursue quantitative easing, the Fed wanted consumers to purchase homes, investors to take more risk and corporations to borrow for capital investment. When the subsidies extend over a decade, it should not be a surprise to see economic actors taking the actions, sometimes unintended, that the purveyors of the subsidy seek.

It makes sense to briefly review the implications of a move higher in rates at this time. In early February 2018, U.S. equity markets experienced a correction that included the two largest single day point losses on record. During January, interest rates climbed steadily with the 10-year rate moving higher by 30 basis points. The 10-year rate increased 32 basis points between August 31 and October 3. We are not forecasting, nor do we believe there should be another equity correction, but if, and as, rates move higher over the coming months it is reasonable to expect reactions in markets and the economy. Fortunately, from a macro perspective, it appears the economy is robust enough to withstand the increase as major sectors do not seem to be over-levered.

According to the Federal Reserve, the U.S. household Debt Service Ratio (DSR) came to 9.84% as of the second quarter of 2018. The ratio was split into 4.24% for mortgage obligations and 5.60% for other debt service obligations (credit cards, personal loans, student loans and the like). The DSR measures how much households spend, as a fraction of their disposable income on debt-related obligations. The Fed also provides an estimate for consumer payments that could be considered proximate to debt payments, like monthly rent, insurance, auto leases and property taxes. Altogether, these are called the Financial Obligations Ratio (FOR), which totaled 15.31% as of June 30, 2018. As a comparison, on June 30, 2007, the FOR was 17.83%, the DSR was 12.96% and the unemployment rate was 4.6%. Current indicators do not suggest consumers are overly levered nor imminently at risk should rates continue their gradual ascent.

The U.S.'s most indebted entity is the federal government. According to the Treasury Department, the government has approximately $15.8 trillion in public debt. Given the budget's annual outlay for interest, it would appear the government's average borrowing cost is about 3.31%. Interest payments constitute 12.4% of the annual budget, a sizeable share, but manageable at higher rates. Separately, measured by the Bloomberg Barclays Municipal Bond Index, states and municipalities have about $1.5 trillion in debt. With the benefit of tax deductibility, we do not believe the municipal market faces meaningful stress from higher rates.

Finally, it is challenging to compute U.S. business' aggregate debt and annual interest costs. Using indexes and Fed data, a reasonable estimate of total debt is $13.4 trillion.[1] While aggregate debt levels have increased, credit metrics have not deteriorated meaningfully because earnings have improved. Certainly, credit spreads and default data suggest higher rates will not likely uncover hidden leverage. In a recent Bloomberg News article about risk in the corporate bond market related to M&A related issuance, the authors reference the $5.1 trillion investment grade corporate bond market. Citing the large share of BBB rated bonds in the index, the article worries companies promising debt reduction may be challenged in a slower economy or if business expectations falter. In particular, companies receiving ratings leeway from

[1] Sources: Federal Reserve, ICE BAML Index Data

the agencies after large M&A transactions may be downgraded below investment grade. Indeed this is a risk, but more likely, companies will manage their debt levels to optimize their cost of capital while taking advantage of a stronger economy.

In summary, a macro-economic review does not reveal excesses of leverage across broad sectors of the economy. However, it remains likely some borrowers and industries will be adversely affected by higher rates, just as they may have benefited from lower ones. A prevalent narrative in 2018 related to the effect on emerging markets of tighter financial conditions. The borrowing that led to this narrative may be exquisitely illustrative of the reason restoring market based rates is critical. Along with the normalization of rates, we would welcome the restoration of risk analysis as we all "search for yield."

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GIA Partners, LLC

At GIA Partners, credit is in our DNA. We are a bottom-up credit manager who has managed credit portfolios in virtually every part of the world's fixed income markets as well as through some of the most severe credit events in history. Additionally, our investment team has the distinction of being among the first to recognize and actively invest in global high yield and emerging markets debt.

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