Flossbach von Storch
RESEARCH INSTITUTE

COMPANY 03/05/2023

Interest rates & stock market: Are the shoulders strong enough?

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Summary

Is the rapid rise in interest rates over the past twelve months a risk for the equity markets, or are companies' shoulders strong enough to bear the inevitable higher interest burdens?

Abstract

Ist der rasante Zinsanstieg der vergangenen zwölf Monate ein Risiko für die Aktienmärkte, oder sind die Schultern der Unternehmen stark genug, um die unvermeidbar höheren Zinslasten tragen zu können??

First the pandemic, then inflation: for the Amsterdam-based clothing brand Scotch & Soda, this is one liquor too many. In March, the fashion label, which also has numerous shops in Germany, filed for insolvency for its Dutch business. The reasons were "serious cash flow problems" after the lockdowns during the pandemic, high energy prices and inflation, Scotch & Soda explained.

Yields on bonds with ratings within the BBB category, for example, have risen considerably - both in euros and in dollars, most recently to just under four and just over five percent respectively

This means that loans from the company are also under fire. Not explicitly mentioned, the sharp rise in interest rates probably also plays a role, which has made the refinancing of debt for all companies in the past twelve months, if not always more difficult, at least more expensive.

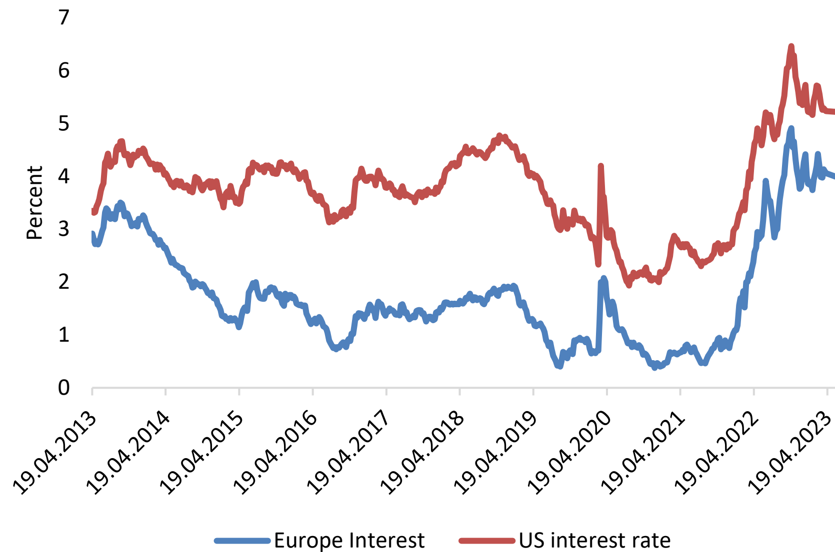
German Siemens, for example, had to offer an interest coupon of 3.5 percent this February to bring a €500 million bond with a 13-year maturity to the market. Almost exactly three years ago, investors were satisfied with 0.5 percent annual interest for a similar bond from Munich (12-year maturity, 750 million euros volume).

Interest service increased sevenfold

The interest service for new debt or debt to be refinanced has thus increased sevenfold for the company listed in the German share index (Dax). In this context, Siemens benefits from having an above-average credit rating at the top end of the investment class, where an elite group adorned with A ratings hangs out. Below that, in the weaker area of investable securities that are still considered safe, things get a lot more expensive.

Yields on bonds with ratings within the BBB category, for example, have risen considerably - both in euros and in dollars, most recently to just under four and just over five percent respectively (chart 1).

Chart 1: Yields of corporate bonds with medium credit ratings*



*Europe Composite BBB+ BBB BBB- Yield BVAL Curve 10Y and US Corporate BBB+ BBB BBB- Yield BVAL Curve 10Y, Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023. **Historical performance is not a reliable indicator of future performance**.

This is where most debtors congregate: roughly half of all corporate debt has a rating of BBB+, BBB or BBB-. And this is also where the average credit rating of corporate debtors is found. Below that begins the so-called *junk* area, which contains bonds with an increased risk of default that security-oriented investors avoid.

The fact that higher interest rates make debt servicing more expensive for all companies with financing needs requires no further explanation. From an investor's point of view, the question is to what extent the jump in yields can be shouldered by corporations that have been spoiled by the years-long interest rate trough and are therefore possibly carefree.

Does more expensive debt put the brakes on share prices?

Even if this should be the case, there is the equally important question of the extent to which the very rapid turnaround in interest rates will have a negative impact on balance sheets and profit and loss accounts, which the stock market could possibly discount in terms of share prices.

So is the rapid rise in interest rates over the past twelve months a risk for equity markets, or are companies' shoulders strong enough to bear the inevitable higher interest burdens?

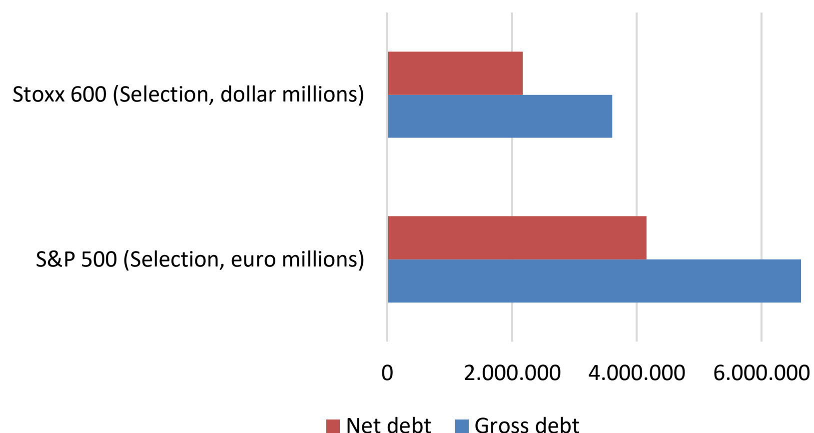
Large indices such as the S&P 500 and the European Stoxx 600 (or Stoxx Europe 600) are suitable for examining this. For a valid analysis, it is necessary to adjust the two indices with their total of more than 1100 companies, especially for banks, insurance companies and financial holding companies. These are difficult to analyse with classic industry indicators and would distort an overall view beyond recognition.

After the selection, exactly 448 companies remain from the S&P 500 and exactly 491 from the Stoxx 600.[1]

The selected S&P 500 companies most recently reported net debt of $4157 billion (average per group: 9.3 billion). At the same time, 65 companies had a total net cash position of 715 billion dollars (average: 11 billion), so that 383 companies had net debt of 4872 billion dollars (average: 12.7 billion). Excluding the cash of all selected companies, the total gross debt is 6636 billion dollars.

The selected Stoxx 600 companies most recently reported net debt of €2169 billion (average per group: 4.4 billion). Of these, 92 companies reported a net cash position of more than 230 billion euros (average: 2.5 billion), so that net debt of more than 2399 billion euros (average: 6 billion) was distributed among 399 companies. Gross debt was 3516 billion euros (chart 2).

Chart 2: Debt situation of selected S&P 500 and Stoxx 600 companies



Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

[1] For this purpose, due to a lack of valid data, a few utilities and some real estate REITs, among others, were not taken into account. However, not all companies assigned to the financial sector by index providers were eliminated: Stock exchange operators or rating agencies, for example, are included in the selection. Debts of the financial subsidiaries of car manufacturers, on the other hand, are not. In the Stoxx 600, data from non-euro companies were converted into euros.

The absolute figures only show the dimension of the debt that has increased in recent years. Since the end of 2017, the gross debt of the selected S&P 500 companies has increased by 47 percent, with a net increase of as much as 91 percent.

On the one hand, the selected US companies have reduced their cash by eight percent in this period (the number of corporations with a net cash position has decreased by a third); on the other hand, the chief financial officers have apparently gorged themselves in the low interest rate environment and soaked up additional debt.

With a 51 percent increase in gross debt since the end of 2017, the growth of corporations on the old continent is slightly higher than that of their US counterparts. Net debt, however, increased by 46 percent, which is only half of the increase seen at US companies.

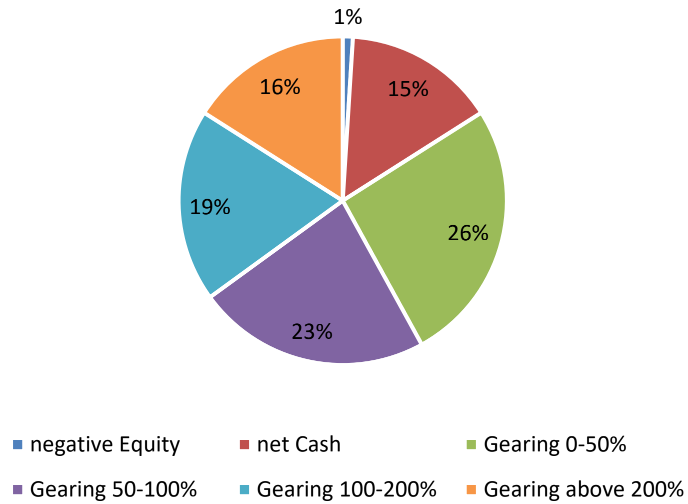
US corporations with weaker key figures

This is reflected in correspondingly weaker ratios for US companies, which investors use to assess debt sustainability. One important indicator is the so-called gearing, where stock market experts put net debt in relation to equity (shareholder capital).

Here, the median of the selected US companies is 63 percent; if companies with a net cash position are excluded, the median value is 77 percent. The selected Stoxx 600 companies have significantly lower ratios of 37 and 50 percent, respectively.

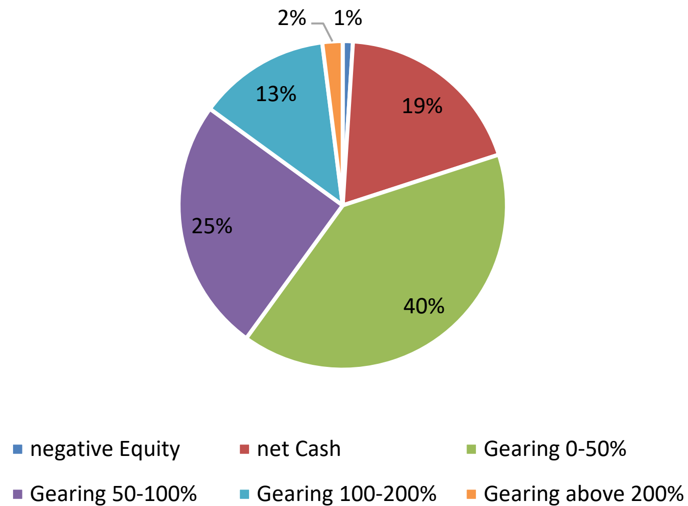
A more favourable picture is also painted by the classification into different gearing classes. Thus, 59 percent of the selected Stoxx 600 companies have a net cash position or gearing below 50, compared to only 41 percent of the American selection group. Only 2 percent of the Stoxx 600 companies have a very high gearing of over 200 percent, but 16 percent of the S&P 500 companies surveyed (charts 3 and 4).

Chart 3: Gearing distribution of selected S&P 500 companies



Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

Chart 4: Gearing distribution of selected Stoxx 600 companies



Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

It is therefore easy to see that the selected US companies not only have higher debt levels - overall and on average per company - but also lag behind their European counterparts in terms of capital structure.

Important debt factor higher

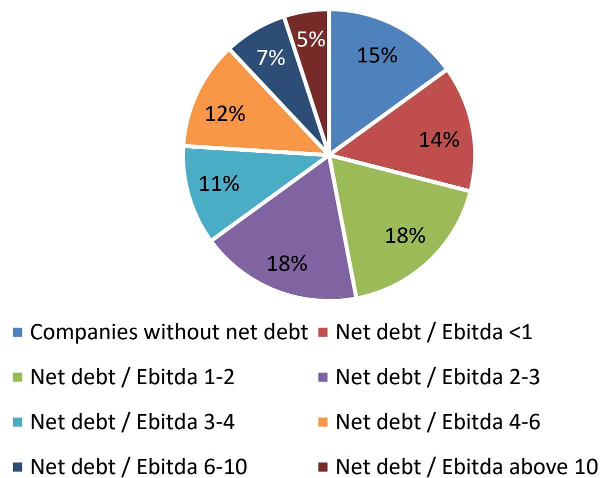
In addition, the ratio of net debt to earnings before interest, taxes, depreciation and amortisation (EBITDA) is higher: while this ratio is 3.5 for the selected Stoxx 600 companies, it is 3.9 for the US companies. Both values refer to those companies from the respective selection that are burdened with net debt.

This *net debt-to-EBITDA ratio* is another debt factor that receives a lot of attention on the stock market and gives an approximate idea of how many years a company could cover its debts from its operating profits before depreciation.

In the distribution of this ratio, the selected Stoxx 600 companies also perform better. 63 percent are in a generally uncritical range from debt-free to a low ratio of below 2.0. Only 47 percent of the selected US companies make the leap into this very safe zone.

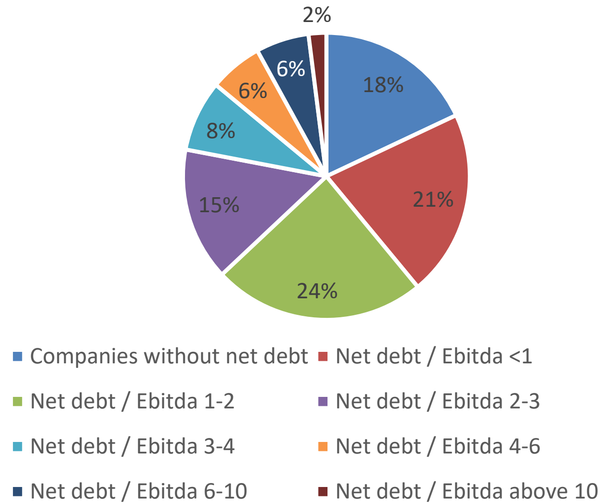
Even at the very top of the debt bar, with very high ratios of more than 9.0 or a negative EBITDA, the US selection performs weaker. After all, one in 20 companies is in this grey zone, while among Europeans it is only one in 50 (charts 5 and 6).

Chart 5: Net debt to EBITDA selected S&P 500 companies



Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

Chart 6: Net debt to EBITDA selected Stoxx 600 companies



Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

It is also worth noting to what extent the companies' businesses generate sufficient income to at least guarantee the payment of interest on their debts. For this so-called interest coverage ratio, investors set the operating result measured by earnings before interest and taxes (EBIT) in relation to the total interest expenses (gross).

The higher the coverage ratio, the less investors have to worry about the ability to repay debt and the stability of companies.

Here, too, the European companies score with an average ratio of 9.4 most recently compared to 9.0 for the US selection in terms of total EBIT to interest expenses of all groups.

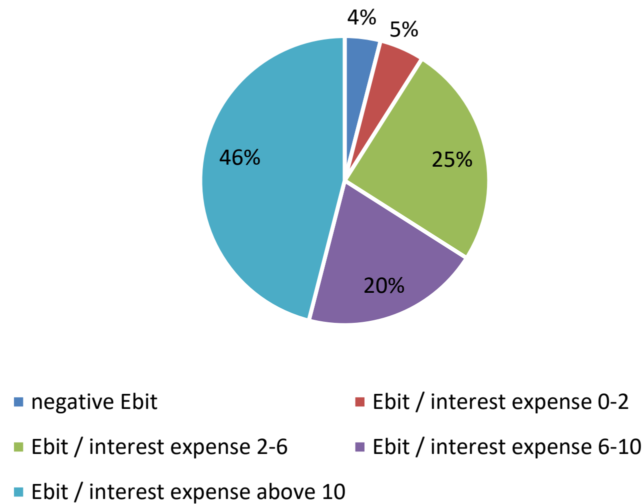
Many companies in the comfort zone

More than half of the selected Stoxx 600 companies are in the comfort zone with an interest coverage ratio of more than 10.0, compared to 46 percent of US corporations.

The US selection does better among the group of corporations commonly referred to as *zombie companies*, as they are only considered viable in an unusual, artificially low interest rate phase. Nine percent of the indebted S&P 500 companies are operating in the red or have an interest coverage ratio of less than 2.0, while the latest aggregate figure for the selected Stoxx 600 companies is as high as 16 percent (charts 7 and 8).

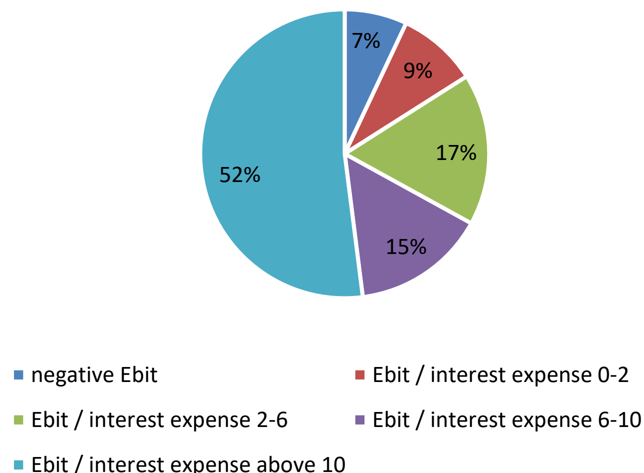
The fact that, in addition to weak corporate earnings, interest rates in the Eurozone were once again significantly lower than in the USA at the low point, thus encouraging greater zombification, is possibly making itself felt here.

Chart 7: EBIT to interest expenses selected S&P 500 companies



Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

Chart 8: EBIT to interest expenses selected Stoxx 600 companies



Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

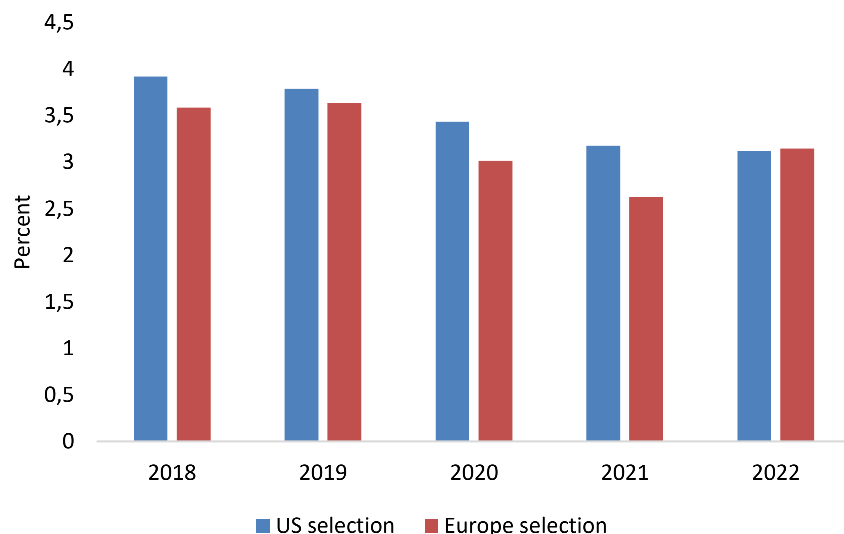
Measured by net debt, the ratio of net interest payments (interest balance) to net financial debt for the selected companies in the S&P 500 is 3.7 percent (excluding companies with net liquidity). For the selected Stoxx 600 corporations, the ratio was most recently 3.3 percent.

In the traditional approach, however, investors are guided by the interest expenditure on debt capital, without taking the cash position into account. It is true that companies regularly repay parts of maturing debt capital with cash - but then usually out of the current cash flow. In contrast, the CFO prefers to keep the iron reserve - if available - on the balance sheet in order to be able to cover short-term expenses without borrowing.

Higher interest rates have an impact

Calculated according to this classic view, the effective interest rate for US companies on debt capital in 2022 decreased again minimally by 0.06 percentage points to 3.12 percent compared to the previous year. For the selected Stoxx 600 companies, on the other hand, the interest rate increased by 0.42 percentage points to 3.15 percent (chart 9).

Chart 9: Effective interest rate on debt capital of selected S&P 500 and Stoxx 600 companies



Interest expenses as a percentage of average current and non-current liabilities calculated from (closing balance of the previous year + closing balance of the current year) / 2. Source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.

This difference in development may be due to different refinancing dates of the companies, the average-oriented calculation method and currency influences.

Dax companies in the European average

For comparison: In the Dax (excluding insurance companies and banks), the interest expenses of those companies with net debt on their balance sheet were 18.3 billion euros in the past fiscal year. With 452.8 billion euros in net debt at the end of the year, which made for a related interest rate of four percent.

In terms of interest expenses to average debt capital, the Dax industrial companies are even lower in interest than the selected Euro-Stoxx 600 and S&P 500 companies: Measured against this, they last paid an effective interest rate of just under 2.7 percent; in 2013, this rate was still slightly more than double. Siemens, for example, recently even managed with only 1.43 percent interest (2013: 3.61 percent).

Since companies largely finance themselves in the medium to long term, the strong rise in interest rates is only reflected slowly and in the medium term. This can be seen in the current results.

Interest income rises steeply

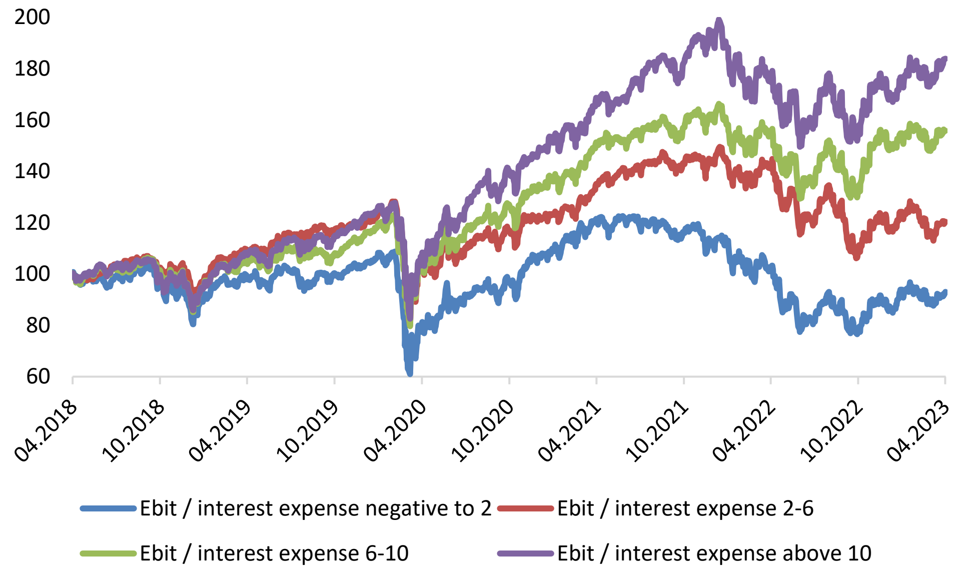
The debt capital is sluggish, the treasurer, on the other hand, is agile and flexible. This is shown by the interest income generated by the selected companies in 2022. For example, interest income at the selected European corporations jumped from 16.7 to 28.8 billion euros compared to the previous year. The companies of the US selection collected 22.6 after 12.9 billion dollars in the previous year. So here the higher interest rate level is already having a strong impact, in this case positive, of course.

How does the stock market react?

There is no doubt that an analysis of individual shares requires an in-depth look. After all, what may appear causal at first glance only comes together in a puzzle of many pieces to form a good assessment. Nevertheless, it is worth taking a look at the performance of the respective clusters.

In the S&P 500 selection, for example, the companies that performed best in an ex-post analysis were those that recently had high interest rate coverage. The weaker the coverage, the worse the stock market performance (chart 10).

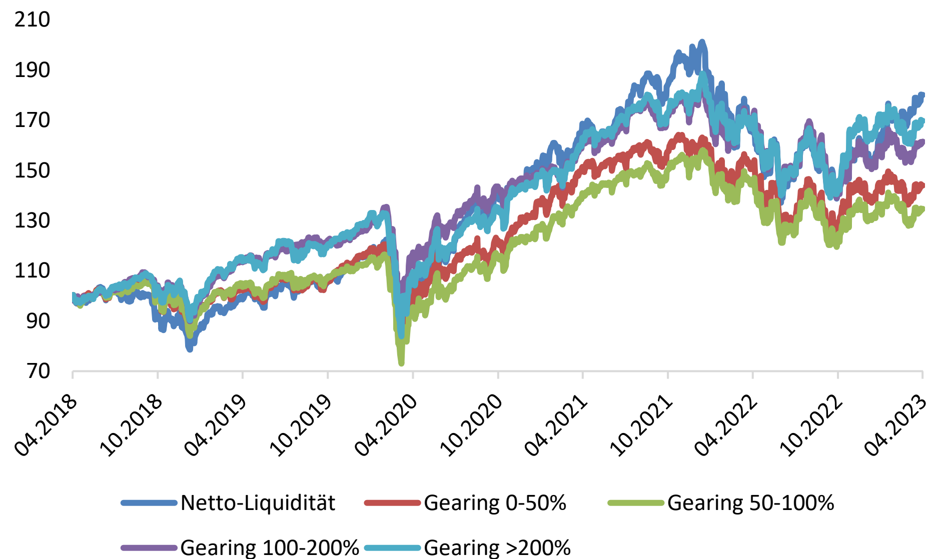
Chart 10: Five-year performance depending on interest rate coverage of the selected S&P 500 companies



indexed, source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.
Historical performance is not a reliable indicator of future performance.

Measured by gearing, the best performance is seen among US companies with a net cash position (in German: *Netto-Liquidität*). Corporations with high gearing also outperform (chart 11).

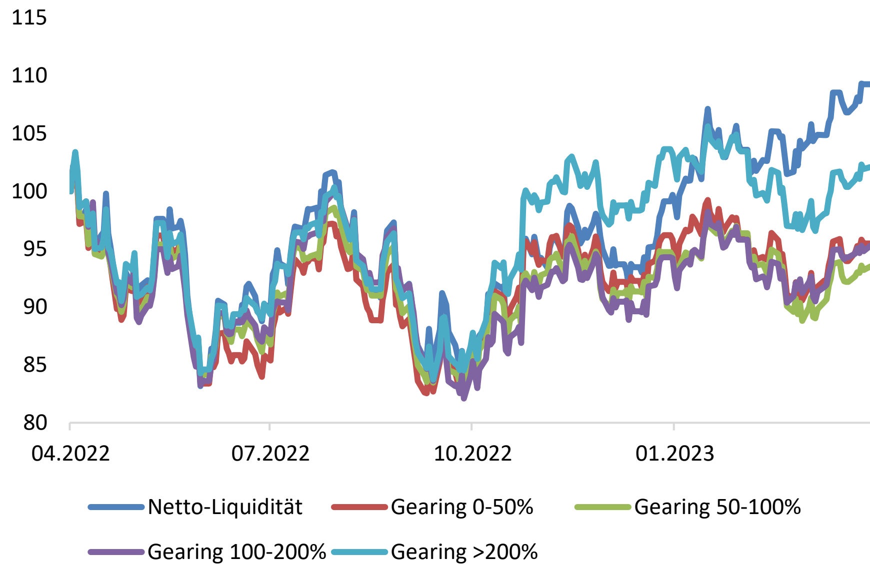
Chart 11: Five-year performance by leverage of selected S&P 500 companies



indexed, source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023. **Historical performance is not a reliable indicator of future performance.**

The shorter-term performance of US companies with a net cash position, whose stock market prices are now well above last year's bear market lows on average, is also evident (chart 12).

Chart 12: One-year performance by leverage of selected S&P 500 companies

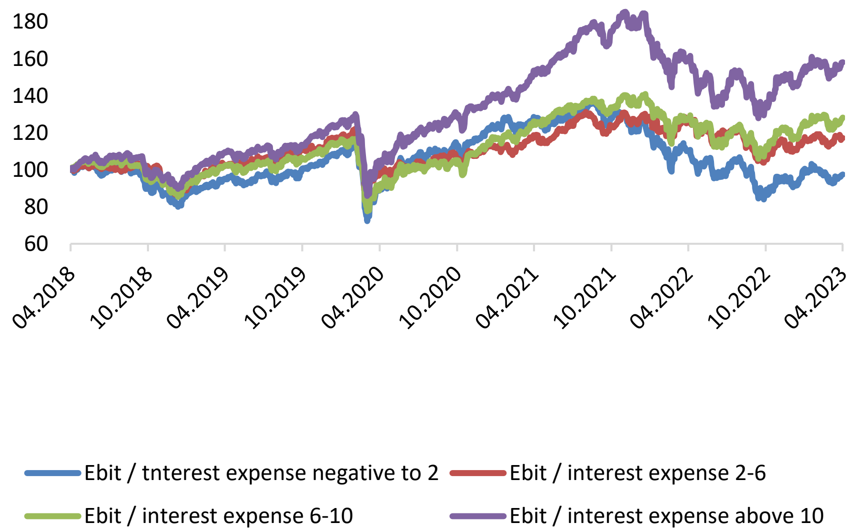


indexed, source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023**. Historical performance is not a reliable indicator of future performance.**

Equivalent results in Europe

In terms of interest coverage, the Stoxx 600 selection yields exactly the same result as its US counterparts: the higher the coverage ratio, the better the price performance (chart 13).

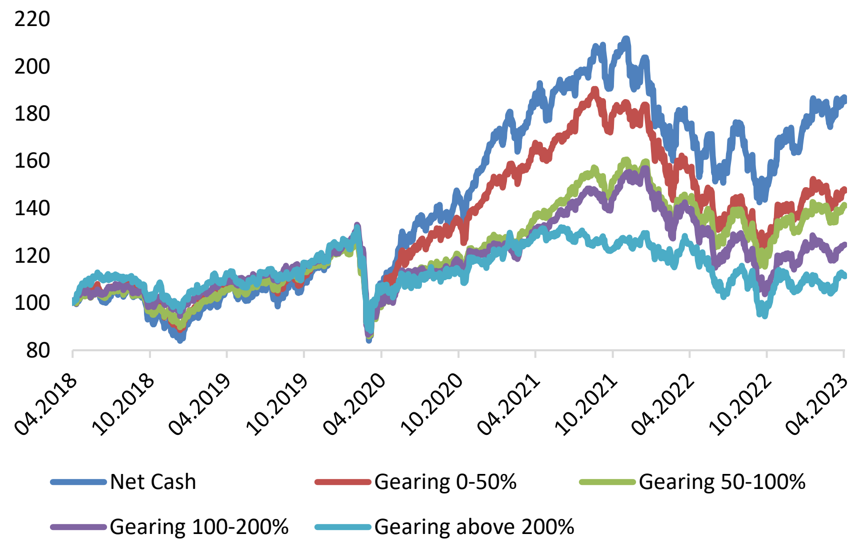
Chart 13: Five-year performance by interest rate coverage of the selected Stoxx 600 companies



indexed, source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023. **Historical performance is not a reliable indicator of future performance.**

In terms of leverage, the best performers are also those companies with a net cash position on the balance sheet. The higher the leverage, the lower the average performance among the selected Stoxx 600 companies (chart 14).

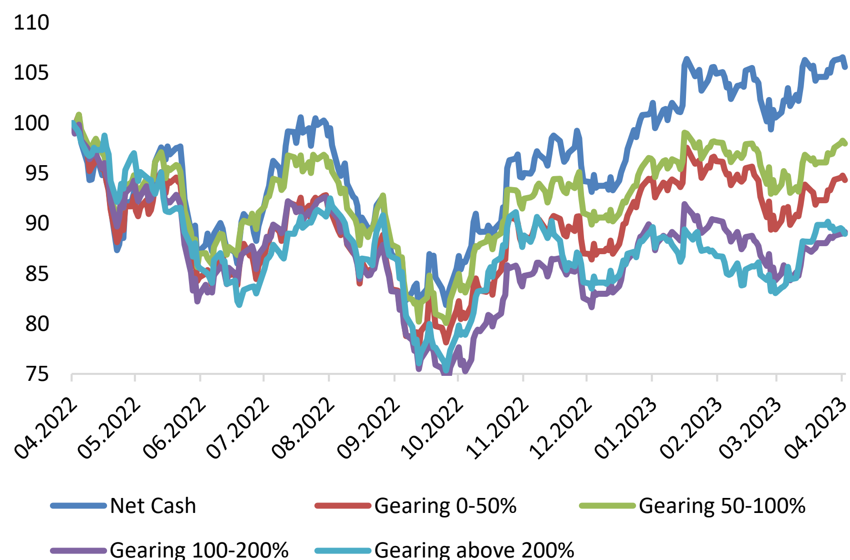
Chart 14: Five-year performance by leverage of selected Stoxx 600 companies



indexed, source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023. **Historical performance is not a reliable indicator of future performance.**

This is even more true on a one-year view. Companies with net cash clearly stand out from indebted groups (chart 15).

Chart 15: One-year performance by leverage of selected Stoxx 600 companies



indexed, source: Flossbach von Storch Research Institute, Bloomberg, as of April 2023.
Historical performance is not a reliable indicator of future performance.

Since the high interest rates have hardly been reflected on the expenditure side of companies overall, but they have already benefited from them on their coffers, profits have not yet been affected on average either. For the selected S&P 500 companies, net interest expenditure in 2022 was even down by a good five percent, and for the European selection it was just 2.7 percent higher than in the previous year.

This will not remain the case unless there is a rapid fall in interest rates back to historical lows, which is unlikely.

Profit increase necessary as compensation

In 2022, net interest expenses accounted for exactly eight percent of EBIT at the selected US companies. Gross interest expenses were eleven percent of EBIT. If bond yields were to settle at current levels for the long term, interest expenses would increase by 70 percent over a period of several years. To compensate for this, the EBIT of the selected companies would have to increase by 7.7 percent - assuming unchanged debt and that interest income remains at the levels seen recently.

For the selected Stoxx 600 companies, net interest expenses most recently accounted for 7.1 percent of EBIT. Gross interest expenses were 10.6 percent of EBIT. Should bond yields settle at current levels for the long term, then interest expenses are likely to increase by about 30 percent. To compensate for this, the EBIT of the selected companies would have to increase by 3.2 percent - again assuming unchanged debt and again assuming that interest income remains at the levels seen recently.

Conclusion

On average, the rise in interest rates has not yet had a lasting effect on companies as far as the expenditure side is concerned. On the interest income side, however, there are clear changes. This is due to the sluggish debt capital, which is only gradually coming up for refinancing.

The higher interest rates may well be bearable on average in the foreseeable future. They would only depress pre-tax and net profits if companies were not able to moderately increase their operating profits and exercise more discipline in taking on new debt.

Accordingly, a combination of unchanged to rising interest rates, higher corporate debt and an (earnings) recession would pose a threat to the stock market.

Overall, the selected European companies are slightly better off than their US counterparts in terms of debt ratios.

10 to 15 percent of all selected companies could get into difficulties, as their ratios indicate that they are not prepared for a permanently higher interest rate level. In this case, external financiers are likely to be the most crucial factor, as the companies' own financial strength is not likely to be sufficient.

Overall, there are clear indications that companies with net cash or high interest cover are not the worst pre-selection when investors are currently looking for investment opportunities in the equity market.

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