Financial Gravity: A Summary

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Why has the rapid rise in interest rates—from 0% to 5.5%—had such little impact on the U.S. economy? Many speculate it's due to a continued shift away from manufacturing and toward services, making the economy less debt dependent and less rate sensitive. But manufacturing hasn't changed much, hovering around 10% to 13% of gross domestic product (GDP) since the 1950s.

What has changed is the amount of borrowing. Scaled by GDP, borrowing has continued to trend upward from around 130% through the 1950s, 1960s, and 1970s to roughly double that today. As with much of the world, the U.S. economy has become more debt dependent, making it crucial to solve this puzzle. To shed some light, we introduce two concepts—first is the idea of financial gravity and second is the tale of a 4-foot man in a 5-foot hole.

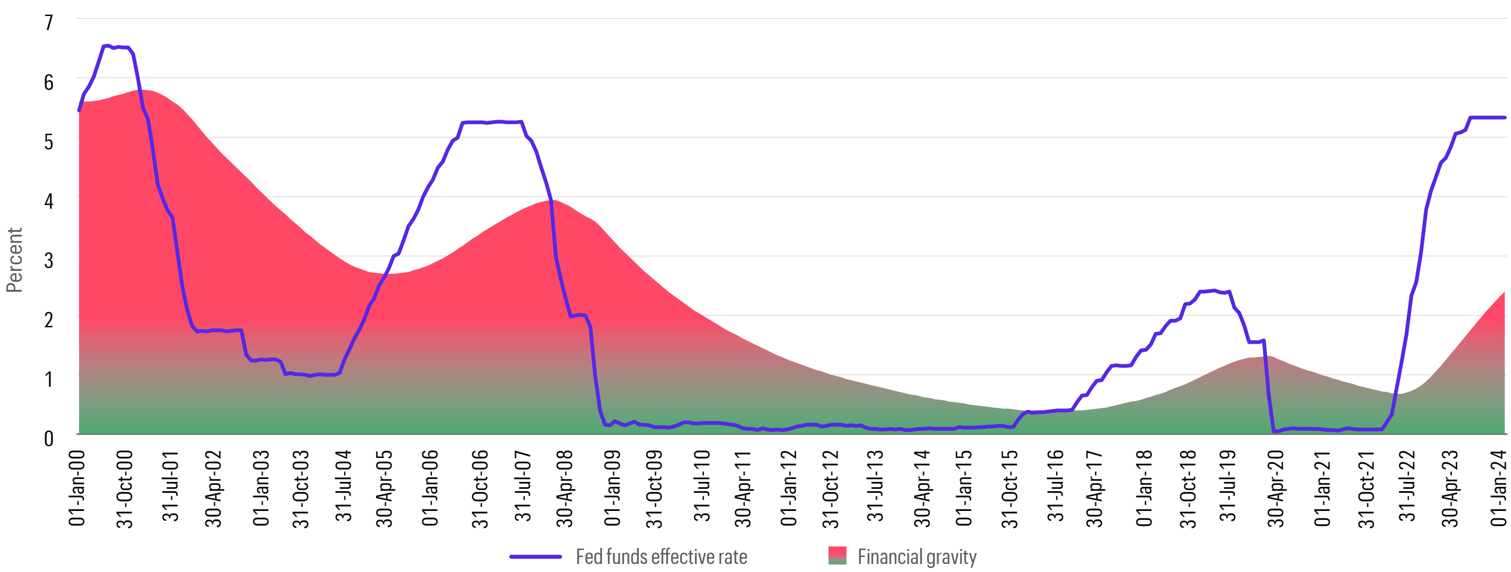
Financial gravity posits that the weight of interest rates on the economy is a function of the level of interest rates and the period of time that rates stay at that level.

FINANCIAL GRAVITY = RATE x TIME

Markets have focused on the number of rate cuts. But the better question is how long rates stay at the higher level. Consider that a 500% interest rate for one minute would capture headlines but have virtually no impact. However, a 5% rate increase for five years could crush the economy. We are currently less than two years into the higher rate environment.

This is illustrated by the period from the post Global Financial Crisis through 2021. Financial gravity was very weak, with rates near zero for most of this time. In that kind of environment, all assets tend to rise as there's little gravity to hold them down. Rates rose rapidly in 2022, but it takes time for the weight of higher rates to be felt. The equity market has priced in very low financial gravity, expecting significant rate cuts soon.

FINANCIAL GRAVITY LAGS CHANGES IN THE FEDERAL FUNDS RATE



Sources: Allspring and Bloomberg Finance L.P., 31-Jan-00 to 31-Mar-24

Time is an important factor because **1)** it takes time for investors' expectations to adjust, **2)** the longer the interval, the more debt that needs to be refinanced and the more new debt that needs to be issued, and **3)** how long it takes to adjust is determined, in part, by how much debt is floating rate (the impact is swift) versus fixed rate (the impact is more delayed). Most U.S. debt is fixed rate, but heavy users of floating-rate debt—such as private equity—are already feeling the pinch of higher rates. In Europe and elsewhere, floating-rate debt is weighing more heavily on consumers.

The tale of a 4-foot man in a 5-foot hole illustrates another key point: The path of interest rates matters a lot. For this analogy, let the maximum base rate an investor can afford be represented by how tall he is. If an investor's maximum base rate is 4%, he is 4 feet tall; the depth of the hole he's in is set by the prevailing base rate, currently 5%. A 4-foot man in a 5-foot hole cannot get out—he can't afford higher loan payments, and he can't afford to refinance. So, a rate cut from 10% to 5% reveals a bunch of tall people in waist-deep holes. These borrowers can refinance, and many new borrowers—those 6-, 7-, 8-, and 9-feet tall—can also afford to borrow. Conversely, we've just moved from a 12-year period of near-zero base rates to 5%, which means a lot of 1-, 2-, 3-, and 4-foot-tall people are now stuck in 5-foot-deep holes. A higher-for-longer environment may spark many defaults. Time and rate—financial gravity—determine the impact.

Investors should think about potential implications of a higher-for-longer scenario, including:

01 Equities have priced in a no-landing scenario. If you're waiting for a meltdown, be patient—equity markets will crack along with the economy.

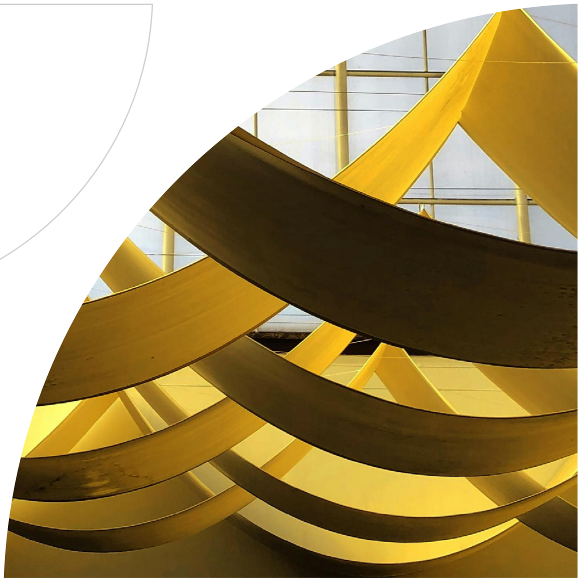
02 Europe may lead the next global recession as over-leveraged consumers spend less.

03 Real estate and other rate-sensitive assets have put off reality by not transacting. Financial gravity is not their friend and neither is time.

04 Private equity could struggle to return capital in a falling market and to pay more on debt than expected. Bankruptcies by private equity–owned firms would then spike.

05 As the economy slows and rates fall, investors may prefer fixed-rate over floating-rate debt. Private credit has their money now but will struggle to raise new capital.

06 Possible winners include gold; high-quality, medium-to-longer-term fixed-rate debt; trend-following strategies; long-volatility strategies; and market-neutral strategies.



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