Should we fear rising long-term interest rates?

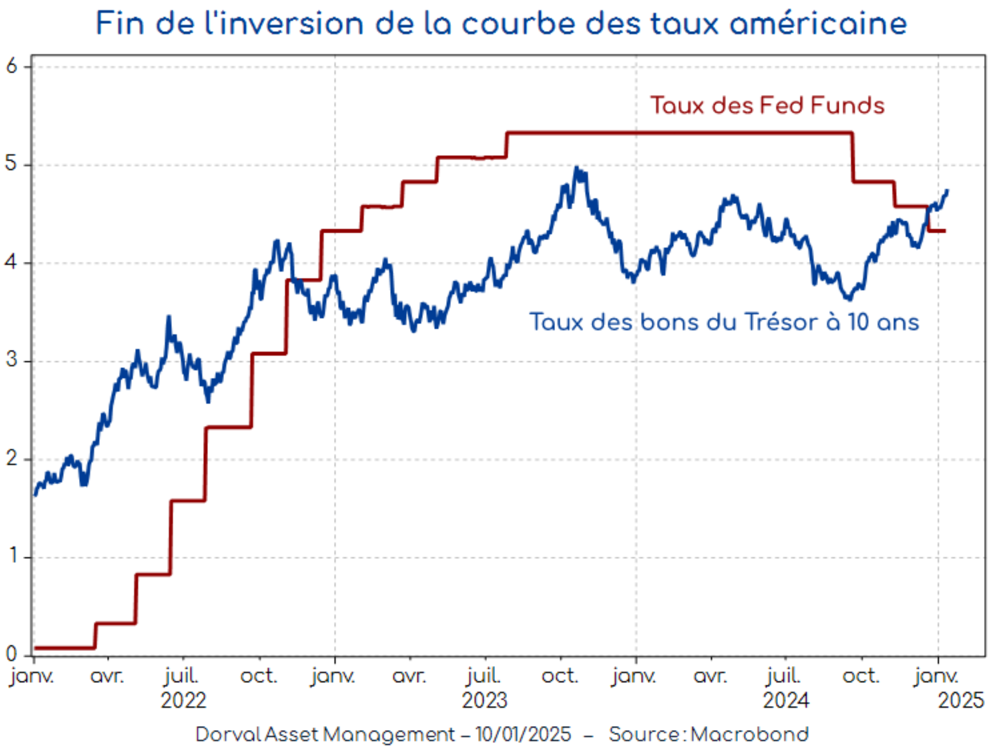
13 January 2025

Dear Clients and Partners,

Rising long-term interest rates are the normal price to pay for US economic optimism. The risk for equities comes less from the current level of long-term rates than from the uncertainties associated with US economic policy.

The nervousness of the US bond market is understandable. Although long-term rates (4.75%) have risen above money-market rates (4.3%) for the first time in over two years (graph 1), the difference is still not enough to comfort investors - the historical average spread is 1.2%. What's more, dollar-denominated money rates may find it difficult to fall further in the months ahead. Firstly, because Donald Trump's economic plans are causing the Federal Reserve to adopt a wait-and-see attitude. And secondly, because the latest employment figures (+256K net new jobs in December) show that the US economy does not need an interest rate cut right now.

End of the inversion of the US yield curve

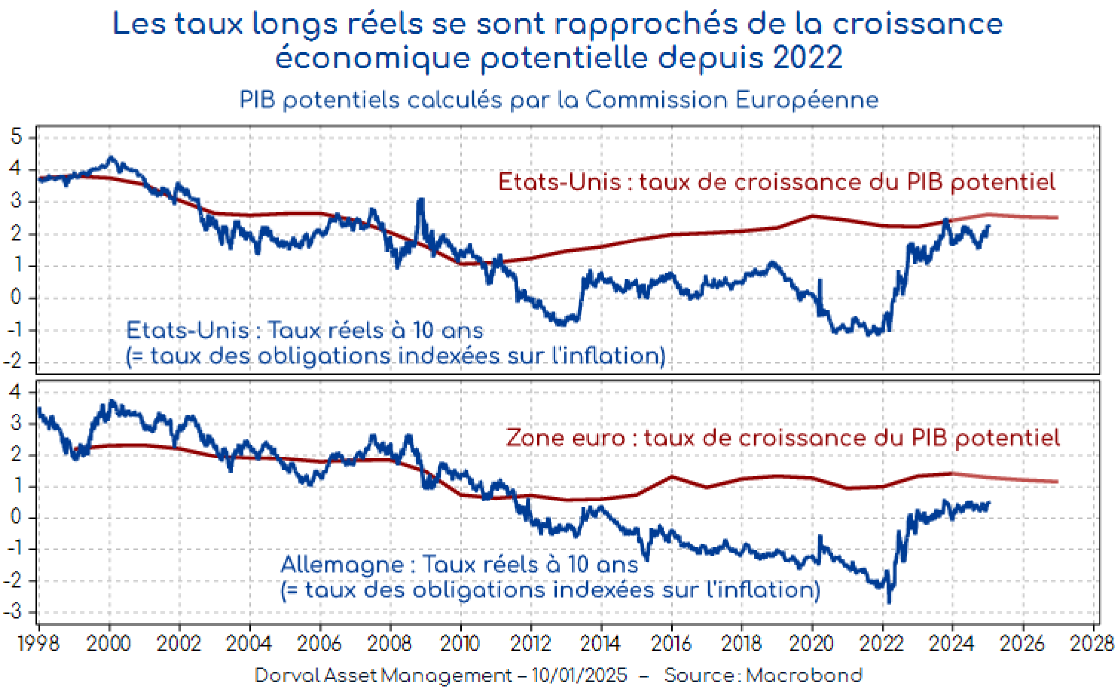


FedFund rates/ 10-year Treasury bill rates

Beyond the markets' recent nervousness, the fundamental debate concerns the equilibrium level of long-term real rates. After maintaining a trajectory fairly close to that of potential economic growth during the 2000s, real rates plunged well below this benchmark during the 2010s, following the financial crisis. This was referred to as "secular stagnation", a situation in which real interest rates had to remain very low in order to sustain economic growth and reduce unemployment. Since 2022, real interest rates and potential growth have turned around, entirely in the USA and partially in the Eurozone (graph 2). This is not yet certain, but it is increasingly likely that low unemployment and high public deficits will be consistent with real rates that are sustainably higher than in the previous decade. We'll just have to get used to it.

Real long-term rates have been close to potential economic growth since 2022

Potential GDP calculated by the European Commission

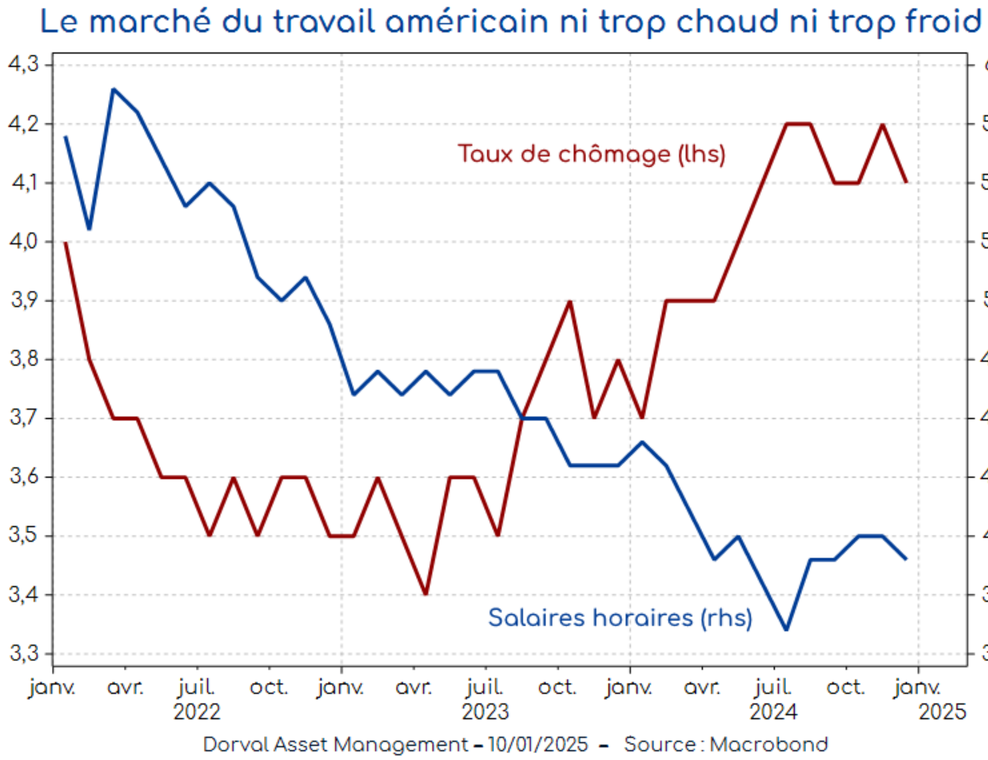


United States: potential GDP growth rate / United States: 10-year real rates (=inflation-indexed bond rates)

Eurozone: potential GDP growth rate / Germany: United States: 10-year real rates (=inflation-indexed bond rates)

Higher US real long-term rates, albeit close to potential growth, have little reason to produce a sharp fall in equity markets, provided inflationary pressures remain contained. The latest employment report shows that wage pressures remained low in December, at +3.9% for hourly wages (graph 3). The "Goldilocks" scenario of an economy that is neither too hot nor too cold therefore still seems relevant. However, this scenario will be tested by the announcements Donald Trump makes at the start of his term. The risks are well known: a policy combining support for demand through tax cuts, a sharp rise in customs duties and a marked reduction in immigration is likely to degrade the quality of US growth by making it potentially more inflationary. President Trump will take office on January 20.

U.S. job market neither too hot nor too cold

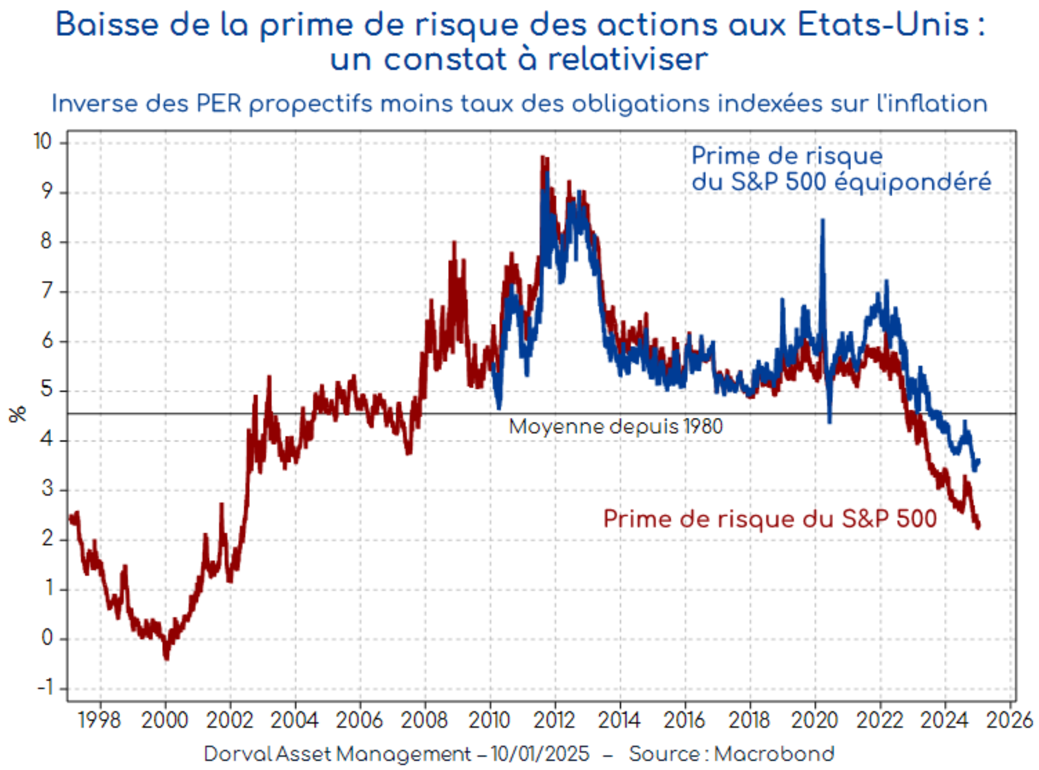


Unemployment rate (lhs) / Hourly wages (rhs)

The other potential pitfall concerns the relative valuation of equities and bonds - i.e., the risk premium. Is the current level of long-term rates likely to generate asset reallocation movements in favor of government bonds? For the S&P 500, the current risk premium (i.e. the inverse of the index's PER minus real long-term rates) is just over 2%. This is higher than in 1998/2000, but still less than half the historical average. However, this observation needs to be put into perspective by a compositional effect that is now well understood by investors. Excluding the "Magnificent 7" (Nvidia, Apple, etc., i.e. 35% of the S&P 500), whose fate has little to do with interest rates, Wall Street's P/E is becoming more normal. Measured by the equally-weighted S&P 500, we obtain a risk premium of 3.5%, which seems reasonable.

Decline in the equity risk premium in the United States: a perspective worth considering

Inverse of forward P/E ratios minus inflation-linked bond yields



S&P 500 equal-weighted equity risk premium / Average since 1980 / S&P 500 equity risk premium

Despite concerns about the speed of long-term interest rate adjustments, we are maintaining our exposure to equities and our investment themes unchanged. However, we have put in place a system of optional hedges to partially protect our portfolios in the event of a rise in volatility over the coming weeks, due to the uncertainties surrounding US economic policy.

Our exposure rates are as follows:

- Dorval Convictions: 65% net exposure to equities, comprising 60% Euro STOXX 50 SRI core basket, 6.5% financials basket, 6% small-caps basket. Hedged using Euro STOXX 50 futures.

Dorval Asset Management

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