Debt Explosion And Interest Rates

The long phase of low interest rates has led to debt financing becoming increasingly cheaper and debt is hardly burdening borrowers any more. If a company or a state can borrow practically at zero cost or for 1% p.a. in the case of long-term bonds, even very high debts become financially viable because the interest payment does not have a significant impact on earnings.

Over the past 10 years, the low interest rates have resulted in various countries incurring unrestrained debts. If a state can place bonds with a negative interest rate, the debt costs nothing at all. Today, for this reason, individual states have debts that amount to over 80% of gross national product:

- Italy 132%
- USA 106%
- Japan 253%
- UK 85%
- France 98%
- Euro Countries 85%

If these national debts were to bear interest at 4% or even 5%, a huge deficit would arise in the national budgets of these countries. None of these countries could afford debts at this level. It would also be impossible to repay these debts through tax revenues - drastic tax
increases and massive wealth taxes would be necessary to bring the debts to a reasonable ratio to the gross national product.

**States and companies as "debt acrobats"

But the states are not the only "debt acrobats". The debts of companies have also reached record levels: Today companies not only finance acquisitions and other investments with loans, but also partly buy back their own shares and thus replace equity capital with borrowed capital. Here, too, a 5% interest rate would bring most of the affected companies to the brink of ruin. The fact that the volume of junk bonds and junk loans also is increasing very sharply due to the combination of a good economic situation and the very low interest rates is particularly problematic. **2019 is a record year**, far exceeding the previous records set in 2008.

The indebtedness of companies naturally follows an economic logic, since outside financing is considerably cheaper than equity capital. On the one hand, interest today is clearly lower than the return on equity (reported profit divided by the market price of the shares), but on the other hand interest is also tax-deductible, while dividend payments cannot be deducted from the taxable profit.

**The downside of debt**

The high level of debt, however, shows its downsides in recessions and individual declines in corporate profits. In financial stress situations, high levels of debt financing can lead to severe restrictions on business activities, as the company has too little liquidity due to the high debt burden. This can in extreme cases lead to bankruptcy or liquidation proceedings. These dangers of debt capital financing are, of course, secondary to a positive economic development. **No CFO today who sees the benefits of cheap debt financing thinks of the fact that in the event of an economic downturn it suddenly becomes extremely difficult to** pay interest and persuade banks and other lenders to continue providing money. **Unfortunately, management today often thinks in very short terms** - the focus is on the rapid advantages of debt financing, while the disadvantages later have to be borne by the successor. Another problem, of course, is that **hardly any CFO today still knows what a recession looks like** or remembers that interest rates can also rise. They belong to the "post-crisis generation", which took up its functions only after 2008 and benefited from a long period of positive economic development.

**What if interest rates go up?**

The central problem of high debts is the increase in interest rates. Nobody thinks of high interest rates in today's environment anymore. Thanks to minimal inflation zero interest rates have become standard consensus. However, one can quickly calculate the consequences of a rise in interest rates to 4-5% for highly indebted companies: The high interest burden tears a massive hole in the income statement.
Most "debt makers" today assume that states and politicians will do everything they can to keep interest rates low because of their high level of debt. The National Bank of a heavily indebted state would never raise interest rates, as these states cannot afford higher interest rates. **According to this logic, interest rates in the USA and the EU should actually never rise again.** Ultimately, however, this argument is wrong. In the end, the market is stronger than national banks. When inflation occurs, interest rates will rise as no one is willing to provide capital unless the interest rate covers at least the loss of purchasing power that the investor suffers from inflation. When inflation occurs, central banks can no longer keep interest rates down because they cannot control investor behavior. It will then no longer be of any use to the central banks to supply the markets with additional liquidity in order to lower interest rates, as the higher money supply will only add to the inflation.

**Danger threatens**

This means that there are two main risk areas for today's mountains of debt: **Inflation and recession. Inflation would affect both heavily indebted countries and companies,** as they would no longer be able to pay higher interest rates on their current debt.

**A recession, on the other hand, only affects highly indebted companies.** States can borrow money even in recessionary phases because they are still considered good debtors. However, companies whose profits decline suddenly no longer receive loans and can no longer issue bonds, as banks and investors shy away from the risk. If they still receive loans, they have to pay massively higher interest. Already in today's "zero interest environment" companies with poor credit ratings have to pay 5-6% interest. Highly indebted companies will therefore suffer massively in the next economic downturn. They will hardly be able to finance their current business and will be forced to take drastic measures to reduce their debts - they will have to sell profitable assets and business units and in extreme cases even initiate liquidation proceedings. Already today there are examples of companies that manoeuvred themselves into such a situation due to home-made problems. Hochdorf or Aryzta are companies that are in a debt trap. Only companies that resist the temptation of cheap money and have a sound financial structure with sufficient equity will survive the next economic downturn.

The Invico team of analysts considers a sound equity base and a healthy balance sheet to be an essential part of the analysis and invests only in companies with a healthy balance sheet and sufficient equity. At present, companies with a high level of indebtedness do have certain advantages. However, these companies will incur all losses in the event of an economic slowdown.
Interest Rates Fall - Expansionary Monetary Policy Continues

In recent years, most analysts have expected the central banks to change their extremely expansive monetary policy and slowly raise interest rates back to normal levels so that interest rates for ten-year bonds will again at least match the economic growth. Such an adjustment of interest rates to the normal level seemed to be correct because the low interest rates led to an inflation of the money supply and thus created potential for inflation. Historical experience since the 1970s has repeatedly shown that a high money supply can lead to high inflation. Moreover, **low interest rates also lead to a redistribution of funds from creditors to debtors**, which puts savers and above all pension funds at a disadvantage - a situation that is unsustainable in the long term.

**Fear of recession lowers interest rates**

The expected tightening of monetary policy began in 2018 with interest rate hikes by the US Federal Reserve and also led to the European Central Bank reducing its purchases of bonds and thus no longer lowering interest rates. When economic growth slowed significantly in the fourth quarter of 2018 and the "economic war" between the USA and China also led to uncertainties in economic development, the central banks changed their course and stopped all interest rate hikes. There are even signs that the central banks intend to lower interest rates again and that they will continue to expand the money supply by buying bonds. In any case, the US Federal Reserve has already made an interest rate cut, while the European Central Bank has more or less clearly announced that it plans to buy more bonds.

With this easing of monetary policy and the corresponding interest rate cuts, the central banks want to prevent a recession in Europe and the USA. The **loose monetary policy and interest rate cuts on the US dollar and Euro naturally put Switzerland under strong pressure as well**. The lower interest rates in the two large currency areas automatically lead to a **higher exchange rate for the Swiss franc**, as the Swiss franc suddenly becomes attractive again when the US dollar and euro no longer offer higher interest rates despite the National Bank’s negative interest rate policy.

**The pressure of politics**

With their latest monetary policy steps, the central banks are of course also reacting to the harsh political criticism of interest rate hikes that came from President Trump himself in the USA. Politicians fear economic recessions and want to avoid them at all costs, since in the USA, but also in most other countries, a president is only re-elected if the economy is doing
well. This is why politicians in the EU and United States of America in particular are exerting strong pressure on the central banks to promote an interest rate trend that is favourable for the economy.

As always, politicians do not think long-term, but act short-term. After 10 years of upturn, a certain slowdown in growth or even a recession would be quite common and actually necessary in the context of cyclical economic development. Recessions are not just bad, they are just as much part of the natural development of the economy as growth phases. They lead to the elimination of excess capacity and the exaggeration of an upswing. If a recession is avoided today by increasing the money supply, demand and inflation potential are artificially created.

The inflation potential is not currently reflected in the consumer goods, which are decisive for the official inflation figures, but above all in the financial assets, i.e. investment properties, equities and bonds, which are all becoming massively expensive. This also shows the danger caused by the central banks' expansion policies - if a recession is avoided by force and prices for real estate, shares, bonds and other investments continue to rise, the potential for the next collapse simply increases. Ultimately, the expansion of the money supply and low interest rates will not avoid the problem of recession, but only postpone it into the future. Now, however, there are many politicians and some economic theorists who assume that a postponement of the recession into "eternity" is possible, so that with sufficiently low interest rates and an unlimited expansion of the money supply all problems can be avoided. But this theory is wrong. The policy of unlimited monetary expansion and low interest rates will come to an end as soon as inflation occurs. So far, inflation has failed to materialise only because China and other Asian countries are supplying cheap goods and services to the US and the EU thanks to economic globalisation. Once this low price potential has been exhausted because the salaries of workers in these regions also are rising, today's money supply policy is at an end. In the case of inflation, interest rates will inevitably have to rise and the higher money supply will additionally increase inflation. The longer the expansion phase, the greater the crash potential.

**What does this mean for us investors?**

Thanks to the rapid reaction of the central banks, we can be pleased that the spectre of a recession for 2019 has been averted, as has the fear of rising interest rates. This means that, in principle, we can continue to expect a positive stock market. At the same time, however, the dangers for the future are increasing. The lower the interest rates, the higher the bond prices will rise and thus the risk of loss will increase should interest rates rise in the future due to rising inflation.

If central bank policies are successful and the economy continues to expand, rising interest rates will ultimately be unavoidable. They are the companions of an economic expansion. For investors, this means that investments in equities are certainly better today than investments in bonds. As a substitute for bonds, the Invico team of analysts continues to favour real estate equities.
The Swiss Franc Is Rising Again

After the Swiss National Bank abandoned the fixed exchange rate of CHF 1.20 for EUR 1 on 15 January 2015, the euro fell sharply. It then recovered in the following months and fluctuated between CHF 1.1 and CHF 1.15 in the following years. In this climate of relative stability, the Swiss export industry was able to grow very well. The devaluation shock of previous years had resulted in all export companies in Switzerland implementing cost-saving and restructuring measures and increasing their competitiveness. These efforts bore fruit between 2015 and 2019, when the Euro remained stable and only moved within this relatively tight band.

New monetary policy of the ECB

Since the European Central Bank intends to implement a very expansive monetary policy again in 2019, interest rates for the Euro are falling, so that the interest rate advantage against the Swiss franc is diminishing. This, of course, makes the Swiss franc attractive - and capital is moving back from the Euro zone to the Swiss franc, which leads to appreciation pressure. This upward pressure is also exacerbated by the fact that the inflation rate in Switzerland in recent years has always been well below the EU inflation rate. Switzerland's national debt is also much lower than the average debt of the Euro states.

Upward movement of the Swiss franc

The value of the Swiss franc has indeed risen again in recent months and weeks. The question, of course, is how high this increase will be. If we look at the development of the Swiss franc against the Euro and the former European currencies. The Swiss franc, for example, has risen again and again in multi-year cycles over the past 50 years. Phases of appreciation were usually followed by a prolonged period of stability or even a decline in the Swiss franc until the Swiss currency rose again.

Cyclic movements

If this pattern repeats itself, the Swiss franc will move down from CHF 1.08 to CHF 1.05 to the Euro in the next wave of depreciation. It is also possible that speculative exaggerations could lead to short-term parity between the Euro and the Swiss franc. In our view, such a high level of the Swiss franc is exaggerated, which is why - in contrast to some other analysts - we do not assume that the parity rate could hold (1:1). The Swiss National Bank will allow the Swiss franc to rise within certain limits, but will intervene in the event of exaggerations. It can be assumed that it uses its usual instruments, i.e. buys Euros and Dollars if necessary and keeps interest rates low or introduces even negative interest rates if necessary. However, the SNB is aware that fundamental factors speak for the rise of the
Swiss franc, which is why it will not resist market forces and will probably allow the Swiss franc to rise to the rate of CHF 1.05 for one Euro.

For Swiss investors who calculate in Swiss francs, the expected rise in the Swiss franc means that they should favour investments in Swiss equities and in companies whose business results are not or as little as possible dependent on the development of the currency. These include, of course, Swisscom, Sunrise and the real estate companies. These companies generate cash flows from Swiss customers and are largely spared currency turbulence.
Are Today's Losers Tomorrow's Winners?

The "Fallen Angels Strategy"

Every year there are shares that fall very sharply because the companies concerned have problems. Sometimes the problems are so massive that a company does not recover at all. This category includes Airopack and a few other companies that have disappeared from the stock list in recent years. Other companies are recovering after a sharp decline, leading to an above-average rise in their share prices. The temptation is therefore great to invest in equities that have seen a fall in prices and the hope to see them return to their old levels.

Opportunities or risks with losers?

However, this hope is often a pure illusion because so many negative changes have occurred in the company and its environment that a comeback is impossible. The "Fallen Angels" of the stock exchange therefore require caution and a rigorous analysis. Blind investing according to the "Fallen Angels strategy", in which every stock is bought that shows a price drop of more than 50%, has rarely brought success. Some stocks are cheap because the companies concerned are in a structurally bad situation and will therefore remain unsuccessful in the future - these stocks will never recover.

Some of the titles that stand out today among the "Fallen Angels" are:

- **Autoneum**
  Autoneum suffers on the one hand from the poor demand for cars, but on the other hand from the self-made problems in the USA, where prices and the product range are not right. A recovery does not seem to be impossible. Autoneum also has structural problems to work on as cars become quieter and the noise insulation produced by Autoneum will therefore be less demanded in electric cars.

- **Aryzta**
  Aryzta produces bakery products that are sold through various channels. Although the business was supposed to be cyclically resilient and relatively stable, Aryzta experienced a crisis in 2018 due to a failed expansion strategy, operational inability and excessive debt. The shares are valued much more favorably than other food companies in terms of sales and EBITDA. However, it is unclear whether the company will ever be able to refinance its debts and how much equity it still has to raise to get the balance sheet in order.
- **Dufry**
  Dufry operates shops at airports and is particularly active in the duty-free business. A strong expansion strategy and the associated high level of debt have led to low earnings expectations. Although this is one of the few retailers that has no competition from the Internet due to its business model, the share is favourably valued in relation to turnover and profit. However, the only argument against a recovery is that the company may have to sell part of its business or raise equity in order to reduce its debt.

- **Meyer Burger Technology Ltd**
  Meyer Burger Technology Ltd manufactures machines for the production of solar cells and has invested heavily in new technologies with high efficiency in recent years. Should the sales forecast by the management actually materialise, the share price would multiply. Meyer Burger Technology Ltd seems to be the only company in the solar industry that is not participating in the current boom. The company's problem is that it has lost credibility in the past due to operational inability and failed acquisitions. Management's promises and forecasts were simply never fulfilled. Even now, there is a danger that the company will again fail to implement the new technologies and promises.

- **GAM**
  GAM is an asset manager in the fund business. In the summer of 2018, the company entered an existential crisis because a fund manager had exceeded his authority. The company showed considerable deficiencies in the compliance area and a high degree of organizational deficiencies as well as a blatant weakness in leadership. The loss of investors led to a sharp decline in assets under management and to major earnings problems. Even if the stock today appears very cheap compared to the remaining assets under management, it is unclear whether the company can ever recover because investors show little inclination to subscribe to the company's funds.

The brief overview of these "Fallen Angels" shows that **a sharp fall in prices is not necessarily a buying opportunity**. On the contrary, there is often a danger that the problems of the affected society will worsen and that it will not recover, but will be caught in spiralling downward. It is also hard to see how companies can improve if the same managers are still pushing the same problems ahead.

**Investing in the right stock is not easy**

For other companies, positive signs are showing both in their business environment and within the company itself, which can actually lead to an improvement and a massive rise in the share prices. The Invico analysis team continuously analyses stocks with a sharp decline in price in order to identify companies with a high price potential or where the fall in price was exaggerated. For the companies mentioned above, we currently assume that two will
achieve the turnaround. The remainder, however, will hardly show any potential for a radical recovery, but will need further drastic measures. Success and failure are very closely related in this category of companies. Only a disciplined analysis can identify the winners.