The End of Easy Money

Low interest rates have distorted stock prices, real estate markets and balance sheets. When central banks finally shut off the spigot, it won't be pretty.

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For corporate treasurers, readily available low-interest cash from bank loans or corporate bond issues has become an essential source of working capital. Alas, the days of easy access to capital look numbered, as central banks become less accommodative and interest rates start to rise. That's likely to spell trouble for real estate markets, equities and corporate balance sheets.

The seeds of this dilemma were planted in banking crisis, when a policy of "quantitative easing" on both sides of the Atlantic saw central banks in Europe and the US aggressively buy bonds issued by the government to ensure liquidity and "stimulate growth." How much good that has done is still subject to debate; but regardless, now governments face the challenge of getting monetary policy back to some semblance of normalcy.

Like the Federal Reserve, the European Central Bank has been buying government bonds. Due to the size of its interventions and the limited supply, it has effectively monopolized the purchase of gilt-edged bonds in the eurozone. Consequently, the main haven for safe investment became largely unavailable to other investors.

Glendinning, Lenovo: If the Federal Reserve sells its government debt, what happens?

"Investors of all types who wo [illegible] bonds have found that market closed to them due to aggressive centra [illegible] to corporate bonds," says Damian Glendinning, Singapore- based group treasurer of Lenovo.

Glendinning argues that this massive shift among institutional and other investors to corporate issues, especially for high-end multinationals whose credit quality is less concerning, has provided major companies unprecedented—and unhealthy—access to large amounts of low-interest funding.

CUT-RATE WORKING CAPITAL

In today's bond market, it isn't unusual for corporates with even relatively modest credit standing to be able to issue billions of dollars' worth of 5- and 10-year US-dollar denominated bonds at rates substantially below 5%—what many would consider "normal" short-term rates in a healthy economy.

Yet "these issues are largely unsecured," notes Ben Singh-Jarrold, a corporate- banking strategist with Finastra in London. "So corporates have come to rely on cheap cash lent to them in the form of bonds that are unsecured, and in many cases owned by institutional and other investors."

As bond rates have softened and their issuance has been made easier, they have become an essential source of working capital. In many cases, companies are also relying more heavily on bank borrowing, which they have become used to rolling over at low rates. After all, while central banks have been actively pushing corporates to rely on the bond markets rather than bank debt, the latter has not gone away: The banks also have large quantities of cheap cash they need to deploy.

In theory, this abundant cash would create new economic activity, through investment in new factories and other creative investments. That was the intention, at least. In reality, it has ended up distorting markets in both the West and Asia.

The use of cash for share buybacks has pushed stock prices up, sending equity price-to-book ratios to irrationally high levels on many exchanges. Low rates have also helped push up real estate prices, also to ludicrous highs in some cases, and not just in Europe and the US. In many key markets, experts think prices would need to come down by 60% to make sense.

Asia has felt the spillover effects of this bonanza through its own real estate bubbles, frothy equity markets and access to cheap working capital for many corporates.

CORRECTION DUE?

At the beginning of 2017, Federal Reserve policy wonks were expecting base rates to climb steadily over the coming year or so. Fed chair Janet Yellen recently cited "somewhat rich" valuations in US financial markets to justify the central bank's intention to continue raising interest rates, yet the Fed has been slow to act.

The growing risk for investors is that delayed stimulus measures and rising global trade tensions could deflate the valuation bubble faster than Fed action can. If the intention has been to replace access to artificial stimulus with real growth against a backdrop of reduced government expenditures and balanced budgets, then progress hasn't been stellar anywhere.

US initiatives to raise import tariffs and leverage more exports are "mired in difficulty," opines Glendinning. At the same time, US defense and other spending is going up, and attempts to modify health- care costs appear to be floundering.

Equity markets continue to be pushed higher by positive earnings expectations, and earnings numbers for the second quarter suggest this trend will continue. But the stock market is missing support from the two other legs of the tripod: stimulus and economic reforms.

With healthcare reform stalled out in Congress, progress on tax reform seems like a distant dream. Weakening retail sales and a falling inflation rate seem to be signaling a weakening economy. If a trade war supplements the absence of stimulus, financial markets will face a double whammy in the months to come.

WORST-CASE SCENARIO

Although the Federal Reserve has stopped buying bonds, it currently owns $8 trillion of government debt. "If the Fed sells it, what happens?" muses Glendinning. Is there a risk of another market crash? As rates rise, profits will be eroded, and their C-level colleagues will pressure treasurers to find other sources of funding in order to limit post-interest earnings damage.

"The type [sector] of a corporate will de ne its likelihood of being affected by the corporate bond market and IR volatility," says Singh-Jarrold. He points out that retailers with larger overhead will need to free up cash from working capital through more short-term financing, while cash-rich firms—for example, in the technology sector—will have different needs.

Singh-Jarrold, Finastra: Corporates have come to rely on cheap cash in the form of unsecured bonds.

"The gap between who has liquidity and who hasn't creates a huge market opportunity for agile banks to deliver bespoke products and services for corporates," Singh-Jarrold adds.

It's an opportunity for nonbanks, too, as corporates will turn increasingly to alter- native sources of funding that bypass banks altogether. Also, access to low-interest cash has often been used to fund longer receivables cycles, and this will once again become a major area of focus. Treasurers— many of whom are rather traditional—will need to become far more savvy about alternative sources of financing, and cash in general will become scarcer.

The flow of easy money into Asia will slow, then reverse. China, especially, has already seen a withdrawal of funds. Real estate and equities will crash. Stresses on China—an emerging economy—will increase as QE disappears, raising the spectres of jingoism, adventurism and missteps.

Central bankers are stuck. Taking the cash away will burst the bubble, and they are unwilling to do that for fear of the con- sequences. But eventually, all bubbles burst.

When bonds dry up and rates rise, funding balance sheets and investment will become much tougher. Banks can't step in, because of new risk controls. Bond-market money will move back to gilt-edged stocks. Receivables pressure will grow, as suppliers reduce payment terms and put pressure on collections. Factoring will grow.

The US has built its economy through cheap debt, mostly sold abroad, and everyone else benefits by selling into the US. In that context, for the US to put up barriers to trade is questionable. It depends on global goodwill toward the dollar. If it destroys that goodwill, beware. The end for US bonds is when China becomes a consumer-driven economy. "If this unwinds badly," Glendinning observes wryly, "we could all be in serious trouble."

Only when the tide goes out do you discover who's been swimming naked.

Warren Buffett

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