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04.30.2024

Positive 'Real' Interest Rates are a Game Changer! (Part One)

Tech Is Well-Positioned When Cash Flow, Balance Sheets and Productivity Matter

SUMMARY

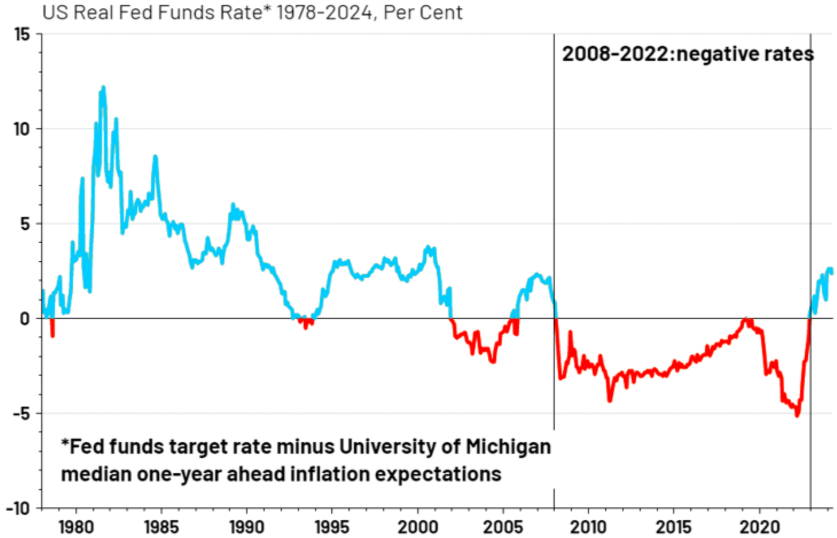
- The US is finally exiting the era of negative real interest rates.
- We think this is positive for savers and balanced portfolio investors.
- We believe mega-cap Technology is well-positioned in a higher rate environment.

(Today is the first part of a multi-part Strategic View series entitled 'Gamechangers,' in which we explore the various investment implications of a return to positive real interest rates in the US.)

Congratulations! if you have been alive longer than 15 years, you just lived through the entirety of one of the weirdest, most subtly unsettling eras in market history...and we are not referring to COVID-19, Brexit or even the Great Financial Crisis (GFC) per se. Rather, we are talking about the bizarre decade-and-a half-long period where US interest rates consistently yielded below zero after adjusting for expected inflation.

Chart 1: Negative Real Rates Historically Unusual

US Real Fed Funds Rate* 1978-2024, Per Cent



Source: LSEG Datastream, RiverFront: data monthly as of April 15, 2024. Chart shown for illustrative purposes only. Not indicative of RiverFront portfolio performance.

In the US from 2008 to 2022, the Federal Reserve's fed funds 'real' target interest rate – 'real' meaning adjusted for consumer inflation expectations over the next year – was consistently negative (see red region of Chart 1). This unusual era of 'Financial Repression' was in our view a by-product of a Fed determined to jumpstart the abnormally low economic growth caused by a series of rolling global economic crises – the GFC, various European crises, and COVID-19 among them. These crises were exacerbated by aging demographics in the developed world leading to excess saving and reduced risk appetite... as well as slowing growth in China and various other factors.

Financial Repression – Not A Victimless Crime

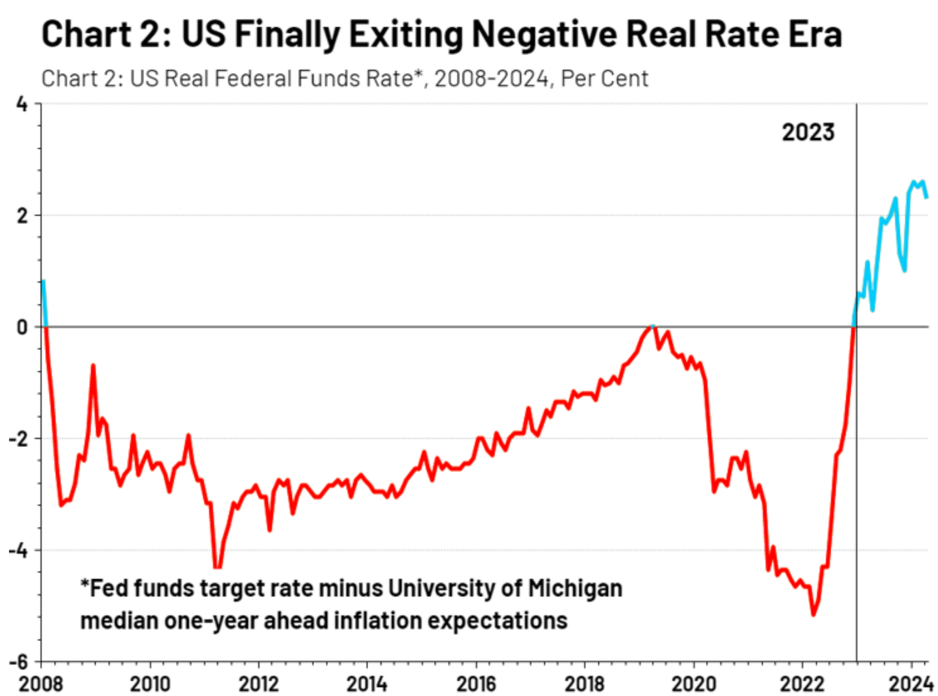
The 2008-2022 Fed had its reasons for such extreme measures, in trying to stimulate risk-taking and economic growth in an era where there was often little of either. And by some measures, they succeeded. Over this 15-year span, US large-cap stocks, as gauged by the MSCI USA index, averaged a total return of almost 11% per year. But prolonged negative real rates also, ironically, created a set of perverse incentives that encouraged excessive risk taking for businesses and investors alike.

For companies, 'negative rates forever' encouraged excess debt accumulation and investment in projects with dubious potential returns. For investors, we would argue that the recent phenomenon of 'meme stocks' and 'SPACs' (special purpose vehicles that allow firms to use shell companies to go public, while sidestepping regulatory due diligence) were by-products of this 'cheap money' era.

Real rates below zero also have potential negative implications for any entity who owes a lot of money, whether sovereign or corporate. Even though low rates make it possible to service higher levels of debt, they also ensure that debt burdens grow over time in 'real' terms, all else being equal. This is particularly a problem for the developed world, as the US, Europe, and Japan are all aging, highly indebted societies to various degrees.

Most perversely, negative real rates penalized savers and anyone on a fixed income – including pensioners, retirees, and the elderly. Negative rates of real return mean that the value of every dollar you keep under the proverbial 'mattress' - in a savings account or in cash – is losing purchasing power. To this point, over the 2008-2022 period, the average real interest rate for US 10-year Treasury securities (adjusted for consensus expectations of CPI inflation, one year forward) was -0.66%…hardly a compelling investment.

For investors who were increasingly moving towards retirement during this era, the lack of positive returns available in 'risk-free' government bonds forced them into a Faustian bargain: either own a higher percentage of stocks than financial planning frameworks recommended - and risk losing their nest egg if stocks corrected - or watch the value of their low-risk assets get eroded away slowly as living costs increased.



Source: LSEG Datastream, RiverFront: data monthly as of April 15.2024. Chart shown for illustrative purposes only. Not indicative of RiverFront portfolio performance.

Patient Exiting the ICU – Investor Implications of a Return to Positive Real Interest Rates

The good news is that the US appears to have finally emerged from the dark age of negative real rates (see blue line, Chart 2, right). Since 2022, the 'patient' is slowly emerging from the ICU, as robust US growth and strong productivity is powering the US economy (see *Weekly View* from 2.27.24, for more on the US economy). This has allowed the Fed to aggressively hike rates over five percentage points, without plunging the economy into deep recession.

The process of weaning our nation off the proverbial 'painkiller' of low rates has begun, in our view. Like any recovery, it will be uneven and spiked with periodic episodes of discomfort. One such episode was the inflationary spike caused by supply chain disruptions in the wake of the pandemic… the after-effects of which we are still dealing with today. But overall, we think the world is better off in a more normalized rate environment… and long-term investors should take note of some of the wide-ranging implications of what we believe to be a structural move back to positive real rates.

We see this new positive real rate era as having a profound effect on several of major stock and bond market dynamics. **The dynamic we discuss in today's *Gamechanger* is a greater investor emphasis on balance sheet strength and cash flow**

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generation, as these things become more difficult for the average company to achieve in a higher interest rate environment. This is a trend that we think will disproportionately benefit mega-cap technology and tech-related companies.

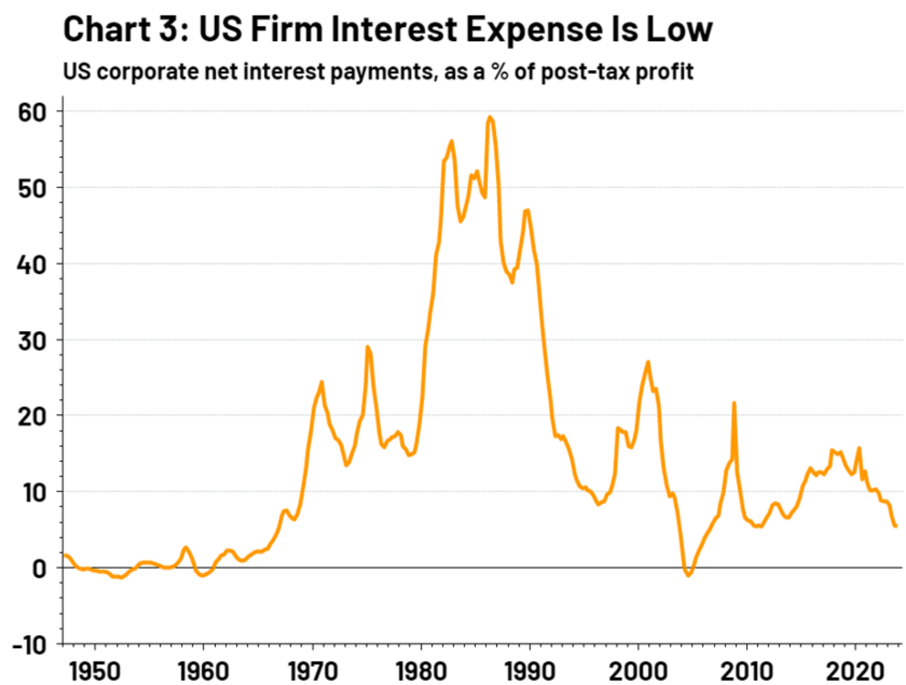
Other dynamic shifts include a 'reflationary' economic tailwind that is likely to benefit certain cyclical value themes such as US energy stocks. Further, we believe that positive real rates will have profound impacts on asset allocation and risk management decisions and outcomes. Specifically, we believe balanced portfolios that hold a mix of both stocks and bonds will be able to generate reasonable returns with less volatility than before, as higher rates of return from fixed income securities should be a bigger portfolio return contributor than during the Financial Repression era. These are all topics we plan to explore in upcoming installments of our *Gamechanger* series.

Gamechanger: With Higher Rates, Balance Sheets, Cash Flows and Productivity Matter Again!

Beneficiaries: *Mega-Cap Tech; Avoid Small-caps*

Balance Sheets Matter Again: Conventional wisdom is that a rising rate environment is a major headwind for companies. For smaller firms who primarily finance operations with floating debt - particularly with suspect balance sheets and uneven cash flows - that is likely true. However, for many large, cash-rich global companies — mega-cap technology in particular — many are paying less in net interest expense as a percentage of revenue than prior to rate hikes, not more (see Chart 3, below).

Many of the largest tech companies have fortress-like balance sheets, with tons of cash and low levels of debt. These types of companies have an incredible advantage over others in a world of higher rates. This is due to the curious fact that these firms have much more cash and cash equivalents sitting in money markets – earning higher rates of return - than they have debt outstanding. This enables them to make MORE money off the non-operating income generated by their higher-yielding floating rate holdings than they are paying in interest expense. **In essence, they are profiting from rates moving higher.**



Source: LSEG Datastream, RiverFront: data quarterly, as of Q4 23. Chart shown for illustrative purposes only. Not indicative of RiverFront portfolio performance.

Sadly, for small-caps the opposite is often true; according to an NDR Research analysis conducted last fall, interest expense is several orders of magnitude higher relative to income for the average S&P 600 small-cap company than for mega-cap tech. Thus, an inverted yield curve with rising short-term rates is creating structural pain points for many US small-caps. In our opinion, this is helping contribute to small-cap's poor relative strength versus large-cap. (For more on why we currently prefer US large-caps to small-caps, see our *Weekly View from 3.26.24*)

Cash Flows Matter Again: In a higher interest rate world, companies will find it more expensive and riskier to drive growth via non-organic means, such as via debt-fueled share buybacks and acquisitions. This dynamic puts lower-quality companies with competitive issues on alert, and disproportionately rewards companies who can demonstrate consistent strong top-line growth…particularly if that top line growth can translate into high free cash flow (free cash flow is cash left over after paying for operating expenses and capital expenditures).

We find the technology sector to be an area where strong revenue growth prospects are abundant. When paired with strong cash flow generation and growth, certain tech companies are attractive investments, in our view. In Riverfront's analysis of

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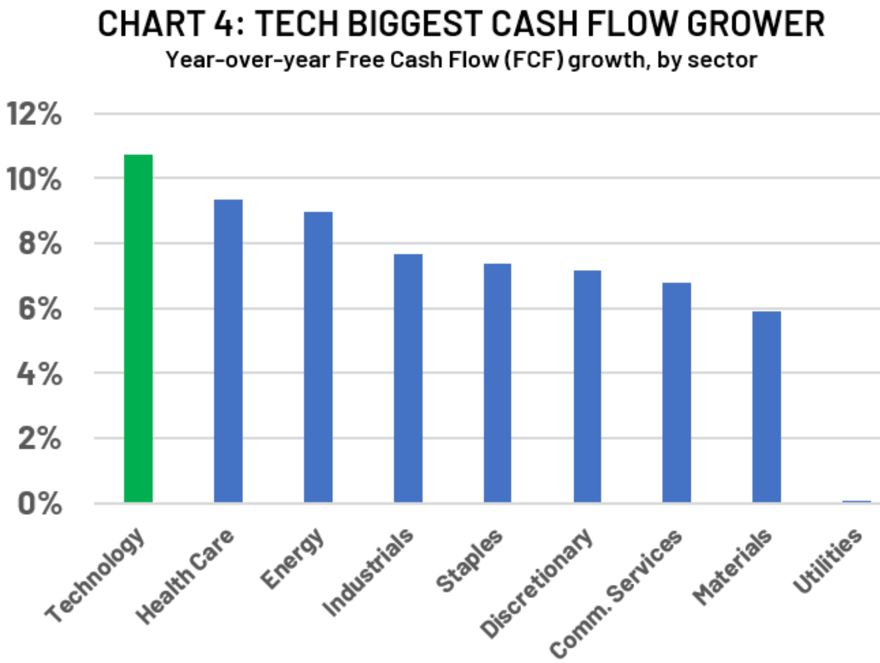
using our proprietary global publicly traded company database (which includes all S&P 1500 constituents as well as the 250 largest international companies, excluding financials and real estate firms) **Technology (green bar in Chart 4, below) was the only sector to demonstrate year-over-year free cash flow growth of more than 10%.**



Many investors are wary of tech company valuations in rising rate environments. This concern is based on the idea that intrinsic value for tech is driven primarily on future earnings (and cash flow) growth, which is less valuable in higher interest rate environments. However, if a company has promising growth opportunities AND is also generating strong cash flows today, the negative effects of higher interest rates on valuation tend to be mitigated by the value of the current cash flows. Further, these cash flows allow companies to self-fund operations without having to depend on capital markets, the cost of which tends to rise with interest rates.

Source: Factset Data Systems, Riverfront; data monthly, as of March 29, 2024. Chart shown for illustrative purposes only.

Oh... and Productivity Matters Again, Too: Structurally higher interest rates also mean that Corporate America will be increasingly focused on finding ways to improve profit margins, as boosting earnings via debt-fueled share buybacks and acquisitions will happen less frequently in a higher rate environment. This puts the onus on firms to find more efficient, productive ways to boost the bottom line, often through productivity-enhancing technologies such as Artificial Intelligence ('AI' – for more on AI, see our *Weekly View* from 9.23.23). We believe the AI boom is just getting started, and that this phenomenon will continue to be a driver of earnings growth for mega-cap tech software and semiconductor companies levered to AI, as Q1 earnings season thus far is already illustrating.

We believe this is one of the reasons why, in our proprietary free cash flow growth analysis above, software and semiconductor companies are two industries who have generated among the highest levels of free cash flow growth over the past year: software at over 14% and semiconductors at close to 11%. We expect this dynamic to continue as Corporate America continues to prioritize driving tech-fueled productivity. (For more on why we like technology as an investing theme, see *Weekly View* from 2.21.24).

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Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Standard & Poor's (S&P) 600 Index tracks a broad range of small-sized companies that meet specific liquidity and stability requirements. This is determined by specific metrics such as public float, market capitalization, and financial viability, among other factors.
The S&P Composite 1500® combines three leading indices, the S&P 500®, the S&P MidCap 400®, and the S&P SmallCap 600®, to cover approximately 90% of U.S. market capitalization. It is designed for investors seeking to replicate the performance of the U.S. equity market or benchmark against a representative universe of tradable stocks.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 610 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

Definitions:

The federal funds rate is the rate banks charge each other for lending their excess reserves or cash. Some banks have excess cash, while other banks might have short-term liquidity needs. The fed funds rate is a target rate set by the Federal Reserve Bank and is usually the basis for the rate that commercial banks lend to each other.

The term cash flow refers to the net amount of cash and cash equivalents being transferred in and out of a company. Cash received represents inflows, while money spent represents outflows.

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Mega cap is a designation for the largest companies in the investment universe as measured by market capitalization. While the exact thresholds change with market conditions, mega cap generally refers to companies with a market capitalization above $200 billion.

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