Eleon Capital Management Ltd.

- MARKET OUTLOOK -

EDITION 10/2023

NET ASSESMENT

OCTOBER 2023

*I*nterest rates are to the financial economy what oil is to the real economy. They affect the value of every asset. When they rise, the value of assets goes down; when they go down, the value goes up.

*E*ver since the Great Financial Crisis (GFC) in 2008, they have, by historical standards, been set by the Central Banks at below-average levels. Post 2021, however, as inflation began to roar its ugly head, Central Banks have steadily raised them to bring inflation levels (and expectations thereof) to their desired targets.

*T*he financial community has much discussion about the trajectory of inflation and, by implication, interest rates. Of the many scenarios envisaged, the most dangerous once touted is falling interest rates as inflation and expectations settle at desired targets. The result of such a scenario envisages asset price appreciation by and large as corporate cash flows improve, supported by falling interest rates.

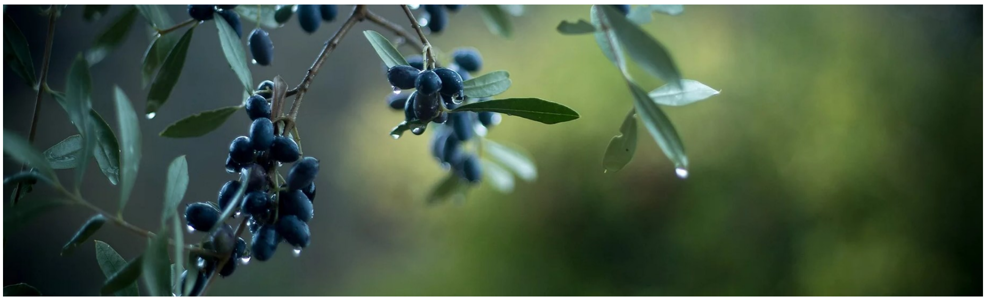
*A*lthough interest rate levels are considered necessary, their trajectory is mainly unknowable and therefore, emphasis on the essential and the knowable is time better spent. However, such a scenario can be problematic because:

- Even though interest rates at present are high compared to the last 14 years or so, they are more 'normalized' when compared over a more extended period. From 2008 to 2021, interest rates were 'abnormal'; however, as investors got used to Central banks holding them lower for longer (unjustifiably) and lowering them every time there was a minor aberration in the financial markets or real economy.
- It seems that Central banks will want to hold interest rates at higher levels so that in the event that an extreme event occurs that may affect both the real and financial economies, they will have the means to stimulate the economy by lowering interest rates that would otherwise not be available if they lowered interest rates now in a more benign economic environment.
- Being privy to real-time inflation data in the real economy, even though official inflation data shows inflation slowing down, this does not appear to be the case. Elevated inflation may continue to run for a while, placing Central banks in a challenging situation.

*T*he bottom line is that in the absence of some extreme or cataclysmic financial or economic event, the most probable scenario will be that interest rates will remain elevated for much longer than expected. By implication, this will have a downward drag on asset valuations and corporate cash flows as debt servicing becomes more expensive, margins eroded due to inflation and revenues slow as real disposable incomes fall.

*A*ssessing investment propositions and valuing assets is a complex process. However, relying solely on the Weighted Average Cost of Capital (WACC) can be problematic. Instead, it is preferred to use a hurdle rate to discount expected cash flows. This rate should be high enough to compensate for the inherent riskiness of equities when compared to long-term government bonds. Additionally, it should allow for a better assessment of the opportunity cost across various assets, regardless of the interest rates set by Central Banks.

18 October 2023



Strong Roots, Sustainable Growth

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