Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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NET ASSESMENT

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*I*n a recent interview with Jamie Dimon, the CEO of JP Morgan, was asked what his assessment of the FED October '23 rate decision was. He noted that, in his opinion, the FED was right to raise rates quickly considering the prevalent inflationary environment and that they were correct to pause the rate hikes for now temporarily. He said that he anticipates that the FED may have to raise rates slightly in the future (although noted that he was unsure) since he sees inflation remaining 'stickier' than generally expected by the markets. Along with Howard Marks of Oaktree Capital in another interview, both believe that we may see a significant 'sea change' in the investment environment where interest rates remain at higher levels than most investors have become accustomed to over the last 23 years. They both further note that while these are simply their opinions and not macroeconomic forecasts, investors need to be cognizant of the fact that the probabilities of such a scenario are both higher now than what they have been and material enough to affect investment decisions.

*W*hy should a macroeconomic variable be so crucial to investors if, as I have noted before, we refrain from making investment decisions based on economic forecasts not because they are not essential but because they are largely unpredictable and their correlations to both the market and other macroeconomic variables unmappable? Jamie Dimon best encapsulates the reason:

"I don't look at it as a prediction but more as risk management for your company."

*S*o, from the perspective of an investor, what are the critical interest rate considerations to factor in our decision-making processes:

- Interest rates affect the value of all assets. The higher they go, the lower the value of assets and vice versa. Also, the greater the asset duration, the more meaningful the impact of rising interest rates will be.
- Higher interest rates change the opportunity nity cost dynamics across the investable universe of assets. For example, there are now fixed-interest assets that offer equity-like returns with less risk.
- Interest rate increases in the presence of an inflationary environment are purposely done to slow down the economy. Therefore, this can have an adverse impact on company revenues as consumer and corporate spending and investment slow down.
- Higher interest rates increase the cost of borrowing for companies and households. Entities, therefore, that are highly leveraged may find that they are unable to service their existing debt, unable to roll over their debt due, unable to raise sufficient debt capital and must pay higher interest rates.
- Higher interest rates either directly or indirectly affect the operating performance and margins of many companies, especially those unable to increase prices without an adverse impact on demand.

*C*onsidering the above scenario, we are studying two new potential portfolio additions. Both stocks have sustainable competitive advantages, returns on invested capital in the region of between 15% to 18%, interest coverage greater than eight times, debt to total capital less than 40%, average historical growth of between 8% to 10%, dividend yield in the region of 3%, modest capital requirements and more than 50% of the valuation if based on the normalized free cash flow of the business.

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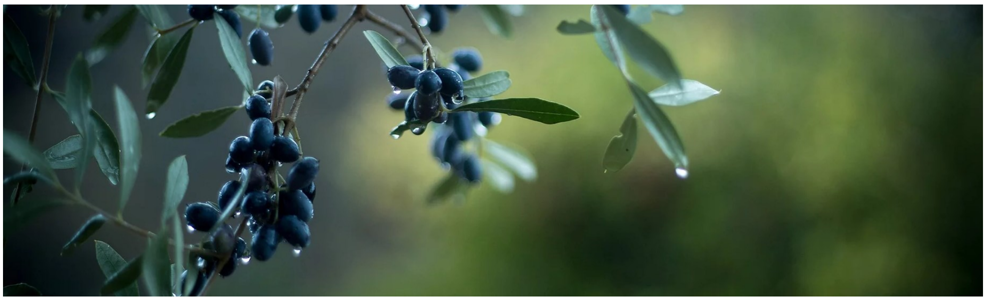

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Strong Roots,
Sustainable Growth

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