The impact of rising interest rates

25 September 2023

Dear Clients and Partners,

Have the biggest rate hikes since the early 1980s left businesses and households navigating a major economic shock? Apparently not.

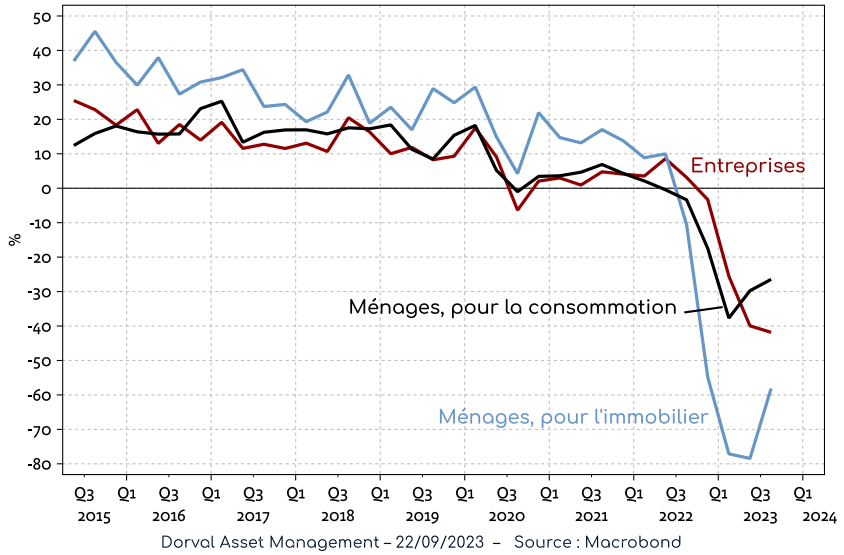
According to most major central banks, the end is in sight for the monetary tightening that began at the start of last year. The Fed, the ECB and the Bank of England seem to consider that their policies have already exerted sufficient pressure. The impact of the rate hikes is already evident in real estate activity and the fall in credit demand reported by banks (cf. chart 1).

Impact of interest rates on credit demand

Survey of eurozone banks – +ve/-ve balance of opinions

Impact des taux d'intérêt sur la demande de crédit

Enquête auprès de banques de la zone euro - solde d'opinions +ve/-ve



Dorval Asset Management – 22/09/2023 – Source : Macrobond

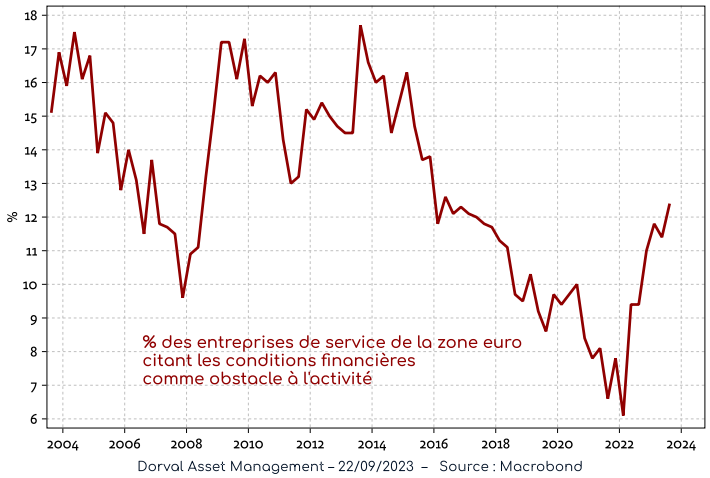
- Businesses / Households, for consumption / Households, for real estate

These developments are hardly surprising given the scale and pace of the rate hikes. But this does not mean that the majority of businesses feel especially restricted by the current financial conditions. According to European surveys, businesses in the service sector – the economy's largest sector by far – consider these financial constraints no different to those from before the ECB's quantitative

easing period. Rather than a shock, this survey data suggests that financial conditions are simply returning to normal after an exceptionally favourable decade.

The financial constraints on the service sector have tightened without causing alarm

Dans les services, le niveau des contraintes financières remonte sans devenir alarmant

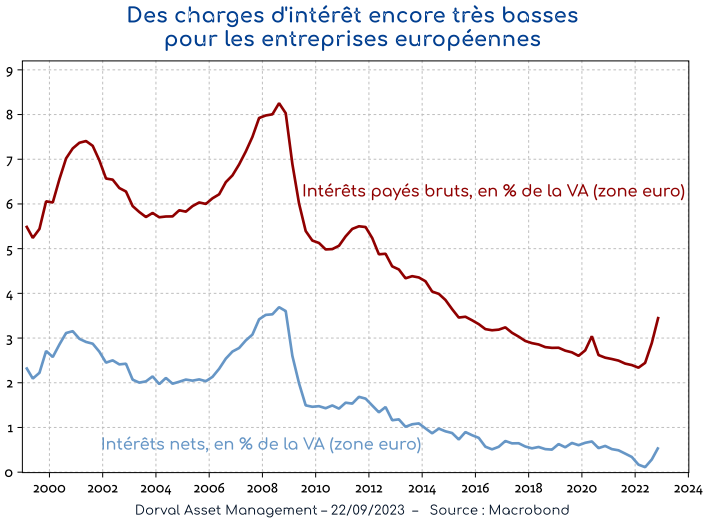


- % of eurozone service sector companies viewing the financial conditions as an obstacle to business

But the impact on activity aside, is the financial health of households and businesses at risk as a result of the rate hikes, which could accelerate the economic slowdown? The latest report from the Bank for International Settlements (BIS) – hardly known for its complacency – suggested that these risks were fairly moderate for the coming quarters for non-financial businesses. Contrary to what had happened in the run-up to 2008, corporate debt was mostly fixed rate and long term in the years preceding these recent rate hikes. According to the BIS, constraints linked to the need to refinance at higher rates should therefore only materialise gradually, from 2025 in particular for the most indebted companies. State aid and the postponing of investment during COVID-19 has also allowed companies to face this period of rate hikes from a very healthy cash-flow position. Last of all, higher profits have also helped to cushion the financial blow.

To date, interest rates have therefore exerted limited pressure on the financial health of non-financial companies. In Europe, gross and net interest expense therefore represented only a very small percentage of businesses' value added (cf. chart 3). Aggregated data in the United States even seems to suggest that, on average, the increase in rates has benefited corporates more than cost them because their abundant cash-flow has allowed them to benefit considerably from rising money-market rates.

Interest expense remained low for European businesses

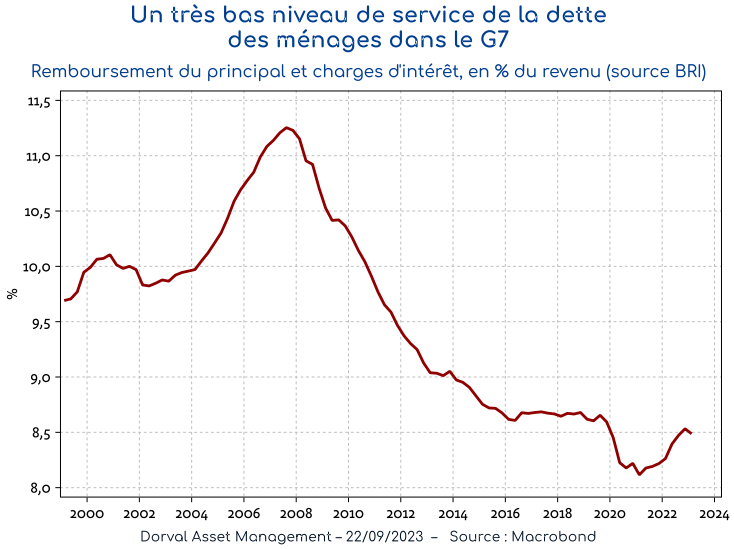


- Gross interest paid as a % of VA (eurozone) / Net interest as a % of VA (eurozone)

Debt burden dynamics also remained benign for households. With the possible exception of Canada, households in G7 countries have not faced significant financial difficulties. The fact that there was much more fixed-rate debt than pre-2008, when floating-rate loans were popular, meant that the rate hikes have had only a moderate impact on households. On average, G7 debt expenses (interest and principal) represent a very similar percentage of income as during the very favourable pre-COVID conditions (cf. chart 4).

A very low level of household debt service in G7 countries

Principal and interest payments as a % of income (source: BIS)



Despite the staggering rise of interest rates, the risk of non-financial businesses and households destabilising therefore appears moderate, if not low. Risks remain concentrated in certain sectors such as residential and non-residential real estate, leveraged activities and of course the financial sector. This sector is exposed to the risk of a fall in the valuation of bond and real-estate portfolios. This is what we saw materialise last year for British pension funds and in the spring for American regional banks. However, these events were well managed and have not had any significant impact on economic activity.

Although episodes of localised stress remain possible, at this point we do not expect a major economic and financial shock resulting from higher interest rates. In our view, the recent volatility on the equity markets is likely mainly due to higher oil prices and the effects of US economic resilience on long-term real interest rates.

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 97%.

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