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On the Minds of Investors

When will higher rates start hurting companies?

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Meera Pandit
Global Market Strategist

Nimish Vyas
Research Anlayst

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When the Federal Reserve raises interest rates, the goal is to cool demand by making it more expensive for companies and consumers to borrow to finance investment and spending. U.S. companies enjoyed over a decade of ultra-low financing costs and issued massive amounts of debt, but 525 basis points of rate hikes later, investors are wondering when the music stops. This time higher rates may not be as painful as quickly and may pose a bigger challenge for smaller companies than larger ones.

Historically, net interest payments for companies rise during and after the Fed hikes, peak during recessions and fall as the Fed cuts rates in response. However, during this hiking cycle net interest payments have fallen sharply after peaking in 2Q19 to the lowest levels since 2006. Non-financial corporate net interest payments as a share of pre-tax corporate profits are at 5.5%, the lowest in at least forty years. Why is this dynamic so markedly different than prior hiking cycles?

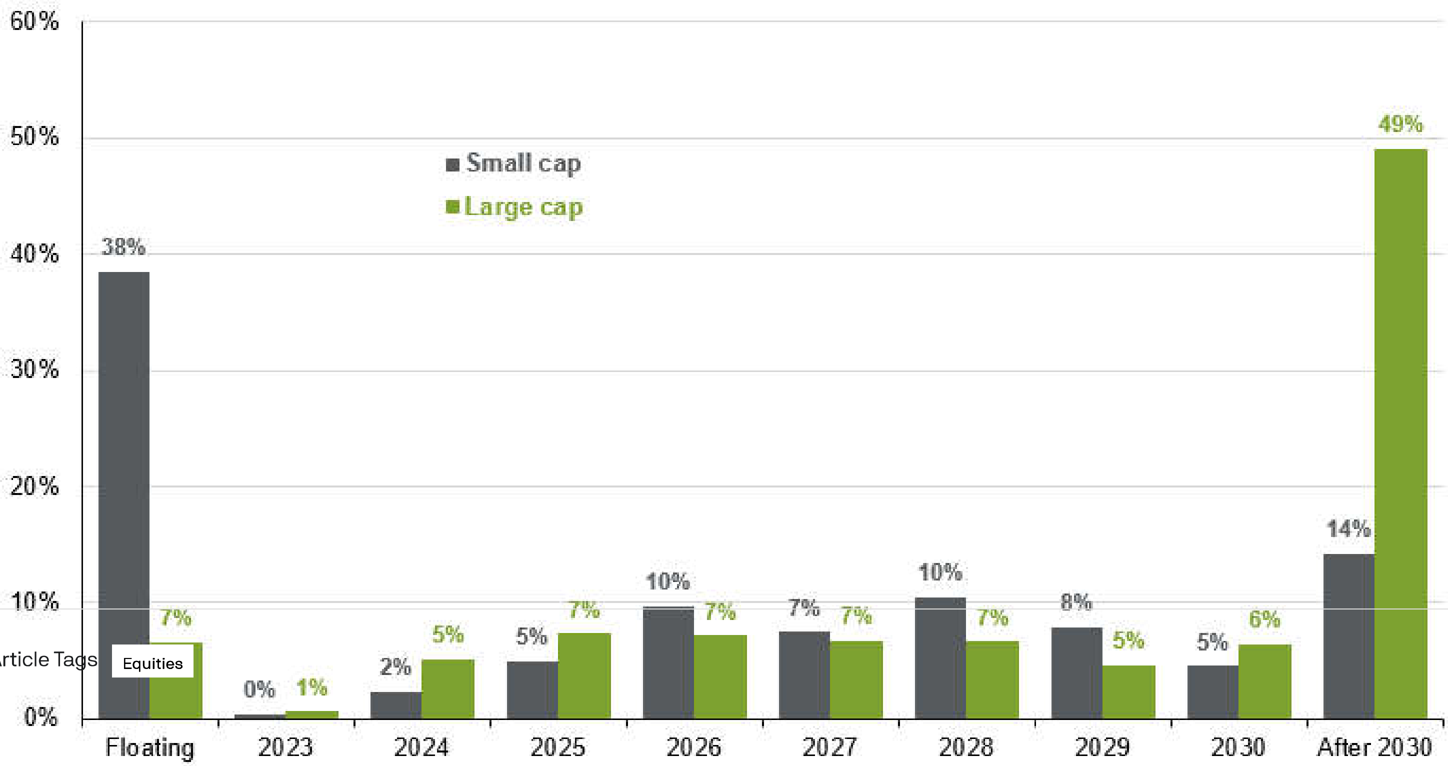
First, many companies took advantage of years of low rates to lock in favorable financing for long periods. About 49% of S&P 500 debt outstanding is fixed beyond 2030, with no more than 7% maturing in any calendar year until then. Second, although cash as a share of financial assets of U.S. companies has come down after peaking in 2Q20, it is still well above pre-pandemic levels. S&P 500 companies have ample cash on their balance sheets – about 31% of their current assets – which is now earning meaningful interest.

Yet, there is likely to be significant divergence between large and small cap companies. Just 14% of Russell 2000 debt outstanding is fixed beyond 2030 and 38% of debt outstanding is floating rate, raising concerns that higher rates could put more immediate pressure on small caps. According to the NFIB, 5% of small business owners cited interest rates and finance as their single most important problem, a small figure but the highest in over a decade.

For investors, large caps may be better insulated from higher rates than small caps, and falling net interest costs can assist decelerating input costs and wages in supporting stabilizing margins. However, perhaps an unintended consequence of higher-for-longer rates is that companies may be increasingly reluctant to borrow new money for long-term R&D or capex, which could pose a challenge to future innovation.

Large and small cap outstanding debt by maturity year

Excluding financials, % of total debt outstanding, USD denominated debt



Article Tags Equities

Source: Bloomberg, J.P. Morgan Asset Management. Large cap = S&P 500. Small cap = Russell 2000. All data are as of Novermber 8, 2023.

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