Debt and Interest Markets

Interest rate markets tasks include the permanent review of issuers' creditworthiness. In this process, market participants form an opinion on the ability and probability of debtors to repay their debts.

The largest debtors in the interest rate markets are national governments. A look at the current prices for government bonds reveals a heterogeneous picture with regard to the interest that governments have to pay on their debt. As a general rule, the interest rates demanded are largely a function of government finances. In other words, the higher a government's debt and budget deficit, the more expensive it is to finance this debt on the financial markets.

In October, interest rates on ten-year U.S. government bonds rose above the 4 percent mark. Earlier in the year, the figure was just 1.5 percent. For two- and three-year paper, yields are now above 4.5%, whereas at the beginning of the year they were still well below 1%. These figures show how fast interest turnarounds, which are currently underway, are taking place. It can be expected that many market participants have been caught on the wrong foot.

The rise in interest rates in the UK is proving particularly exciting. When the government around Liz Truss, which had just taken office, announced its tax cut plans, there was panic selling of British government bonds and the central bank had to step in as a buyer. This reveals the disciplining role of the financial markets. Reckless borrowing, which is commonplace all over the country, has very real consequences. In fact, the financial markets have brought down the Truss government.

Rising interest rates are also plaguing governments on the European continent. While the European Central Bank initially slept through initiating the cycle of interest rate hikes, market participants now are demanding higher interest rates from governments on an almost daily basis. Greece meanwhile is again forced to pay more than 4.5% for ten-year government bonds, and Italy is not far behind. Germany must prepare itself for substantially higher interest payments in the federal budget as well. Firstly, its debt is skyrocketing and, secondly, interest rates for ten-year federal bonds have jumped to around 2.1%. By comparison, at the beginning of the year the comparative interest rate was still negative at minus 0.2%.

The rich country of Switzerland is in a much better position. There, the ten-year interest rate is only 1%. Apparently, financial market participants honor the fiscal solidity of the Swiss. Similarly, there have been no significant interest rate hikes in Japan. There, the central bank is providing stability with an interest rate cap of 0.25% for ten-year government bonds. In return, however, the Japanese yen has fallen sharply in view of the unattractive interest rates in Nippon. A fate not shared by the Swiss franc.

Interest rates play a major role for the economy. The price slumps on the interest rate markets do not fail to have an impact on the real economy and the stock market. For many companies, financing becomes more expensive. For this reason, balance sheet analysis is once again being given greater prominence these days. A good balance sheet with fairly low net debt can become a significant competitive advantage. This is not news to the fund management team at LOYS AG. On the contrary, balance sheet analysis has always been of central importance in assessing the attractiveness of stocks. It's just that it hardly played a role in the market during the times of cheap money. This is now changing, which is why we are reasonably confident about the future.

Sincerely yours,

Fund managers and co-investors

Dr. Christoph Bruns Ufuk Boydak

This text was originally published in German.

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