South Atlantic Capital Management Group, Inc.
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Can Your Stocks Defy Gravity If Interest Rates Rise

According to Warren Buffett, "Interest rates are to asset prices like gravity is to the apple. They power everything in the investment universe".

The gravitational pull downward as rates rise is due to the fundamental question of whether lower risk bonds are now more attractive than riskier stocks. Higher rates also lower the value of stocks by lowering the present value of their future cash flow.

As rates rise, investors are forced to consider whether their stocks are overvalued much like getting on a scale forces you to consider whether you're overweight. That may not be the case, but higher rates are a powerful force that investors shouldn't overlook.

Besides providing more appealing income, rising rates lower stock values which are calculated by discounting future cash flows to the present, a higher discount rate lowers that value. Higher rates also raise borrowing costs for companies, squeezing margins, particularly for overleveraged companies, and can become a headwind to economic growth. This potential trifecta should force investors to consider whether their stocks are overvalued.

As the ten-year treasury yield increased to 4.82% borrowing costs for weaker companies have increased significantly. According to the Financial Times, companies with a bond rating of CCC or lower have seen the spreads required to borrow money increase from 8.08% over the ten- year treasury to 10.53% over, plus ten-year yields have increased. This makes it tougher for weaker companies to roll over their debt and increases the risk of something breaking in the bond market. Companies with significant leverage that were built in a zero-interest rate environment just aren't built to withstand higher rates for a long time.

We think recent earnings growth has been so abnormally high that it is causing investors to defer the typical anxiety about stock values during a rising rate environment. If you believe as we do that earnings growth will probably not stay at these abnormally high levels, you shouldn't ignore the effect on stock prices that higher yields might have.

Earnings growth for the companies in the S&P 500, not participating in the A. I. boom, stayed close to historical norms of 7% while earnings growth for the A. I. related companies in the index has been abnormally high. Excluding mark to market gains on investments, S&P 500 earnings growth estimates for the 2nd quarter are 33% according to Tajinder Dhillon , head of earnings research at LSEG. We think investors should view these earnings growth rates with a high degree of skepticism.

Earnings growth during capital booms can be skewed upward by an accounting quirk. A. I. related capital investment today is immense. For example, the "picks and shovel" companies like chip makers that supply the massive data center buildout recognize 100% of the revenue upfront while the datacenters buying their chips capitalize the cost and expense it over several years.

This capital boom may turn out to be the first one that wasn't beset by excessive build out, but, if it slows or declines as is typical, this **earnings effect reverses** and the suppliers of the datacenters see revenues decline while the builders of the data centers continue to have increasing depreciation expense.

Higher rates come after a renewed flare up in the Middle East conflict and rising expectations that central banks will raise rates to combat inflation from the resulting high energy prices. Higher rates add more fuel to the fire by increasing expected fiscal deficits creating a negative feedback loop. Increased competition for capital as the hyper scalers raise huge sums in the bond market is another contributing factor.
Inflation from higher diesel prices doesn't seem to us to be finished filtering its way through the system and adding pressure to rates.

Currently, the deficit is 6% of GDP. <u>This means nominal growth of the economy needs to be 6%, a tall order, or the country's ability to service its debt deteriorates</u>. This is the highest post war deficit we've run during a period of full employment. A weaker economy typically pressures revenues lower and spending higher causing a negative effect on the deficit. Refinancing government debt at higher rates would further increase the deficit unless fiscal policy is changed.

Recent economic growth has been robust, driven by enormous A. I. capital investment. If this buildout wanes and the economy weakens, the federal deficit could widen highlighting long-term structural problems with our government debt and painting the picture that rates could stay high for a while. The threat of higher rates over the long term is what matters the most to stock values.

We don't see any tangible evidence of progress on the deficit and **<u>see little respite</u>** from consistent anxiety over government debt levels as increased government debt issuance and elevated deficits appears to be on the horizon for the medium term at a minimum.

One way to weigh stocks versus bonds is to compare the higher bond yields to the earnings yield. The earnings yield is calculated as earnings per share over the stock price-- the flip side of the price to earnings ratio. The current trailing P/E ratio for the S&P 500 is about 27.5x, a historically high valuation driven by A. I. enthusiasm. That equates to an earnings yield of 3.83%, a gap of 1.32% versus the 4.82% yield on the ten-year treasury. That is the biggest gap since 2003 according to Gillian Tett at the Financial Times.

Our takeaway is that equity investors should be concerned about future interest rates and whether their stocks are overvalued. Besides a valuation check, what we think is most important during a time when higher rates or a downturn in the A. I. boom could elevate economic stress is to focus on resilient or antifragile companies.

Nassim Taleb, author of several insightful investment books, described anti fragile as a property of systems that gain from disorder, volatility, stress and chaos and grow stronger when exposed to shocks not just resisting them. In investing, that means companies with reliant cash flows, strong balance sheets, and managements willing to take advantage of the chaos if it unfolds.

Please join us for an event on November the 4th at 5:30 at Cape Fear Country Club where we will be discussing this topic in more detail and how it may affect your portfolio. If you would like to join us for this event, please contact South Atlantic Capital at info@SouthAtlanticCapital.

Meade Van Pelt, who is at the helm of the **Harrelson Center's** downtown campus, will also be speaking at the event. The Harrelson Center's downtown campus is home to 40 humanitarian organizations that tackle basic needs -housing stability, healthcare access, family support, food security, youth development, and crisis response. By providing shared services, affordable space and strategic support, the Harrelson Center saves its nonprofit partners more than $1mm every year, which can be used to support the community. Meade and the Harrelson Center are a unique resource with their hands on the pulse of our nonprofit community. If you would like to join us for this event, please contact South Atlantic Capital at info@SouthAtlanticCapital .

Eddie Nowell, with 30+ years in finance, founded **South Atlantic Capital** after roles at Bankers Trust (NY) where he arranged bank financing for Kohlberg, Kravis, Roberts & Co. buyouts. Since founding South Atlantic in 1991, he has been the sole portfolio manager of our Core Equity Composite, which has outperformed the S&P 500 since its inception on January 1, 1992. Mr. Nowell graduated with a B. S. in economics from the University of North Carolina at Chapel Hill and received his MBA from the Darden School of Business at the University of Virginia.

Disclosures

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Performance comparisons are based on historical results and are available upon request. Investors should not assume that future performance will be comparable.

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