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GLOBAL RESEARCH

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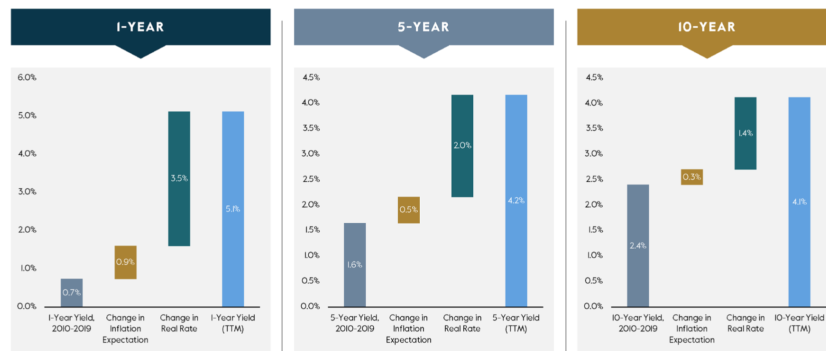
It's that time of the month where a nation turns its lonely eyes to the Bureau of Labor Statistics' "Consumer Price Index Summary." While no one could deny the report's significance to market positioning, monomaniacal focus on near-term inflation distracts attention from more consequential macro developments.

Inflation compensation accounts for a minuscule share of the upward adjustment in interest rates. Most of the movement in one, five, and 10-year Treasury yields is the result of the increase in real rates, or market expectations for the level of nominal interest rates required to hit the Fed's inflation target ***over time*** (Figure 1).

Figure 1: Real Rates Drive Increase in Yields

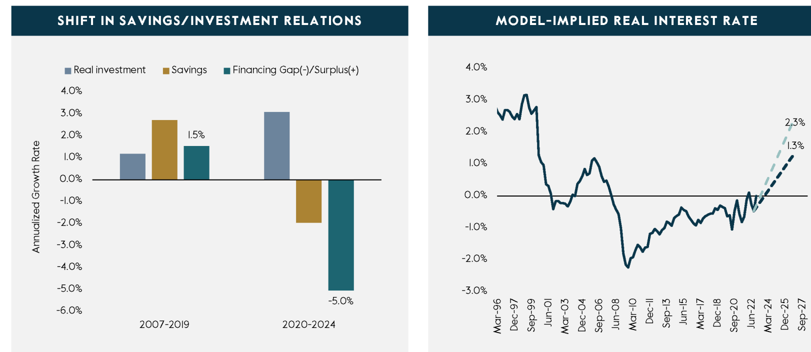


Source: Carlyle Analysis; FRED, April 2024. There is no guarantee any trends will continue. TTM yields are as of April 12, 2024.

Since the start of the recovery from the pandemic, real demand for capital in the U.S. has grown at three-fold the rate of the 2009-19 expansion, led this year by the $200 billion in annual capex of large data center owners, a record 62.8 GW of mostly solar and storage capacity added to the electric grid, a 15x increase in battery factories planned, under construction, or operating, and the boom in the construction of new semiconductor fabrication plants. At the same time, the pool of savings available to fund this capital formation has contracted, due mainly to the increase in the fiscal deficit but also the 50% drop in the personal savings rate attributable to "wealth effects" from higher asset prices and retirement savings, as well as the dissaving associated with higher credit card balances incurred to maintain consumption levels in the face of a cost-of-living shock.

With more borrowers and fewer lenders, is it any surprise to see interest rates rise materially to clear the market (Figure 2)?

Figure 2: More Demand, Less Supply of Capital



Source: Carlyle Analysis; IMF WEO Database, Federal Reserve Bank of Chicago; Bureau of Economic Analysis, April 2024. There is no guarantee any trends will continue. No assurance can be given that any projections referenced herein will ultimately materialize. The lines on the RHS chart represent different variable coefficients.

Economic optimism remains high, as evidenced by the near unanimity on this point at the Milken Institute's Global Conference. But unlike earlier in the year, it now seems to coincide with begrudging acceptance that higher base rates may be the price we pay for the stronger growth expectations embedded in U.S. asset prices. Has the "higher for longer" narrative really seeped into investors' collective consciousness? Perhaps not until the attention paid to the monthly inflation data falls to levels more proportionate to its significance.

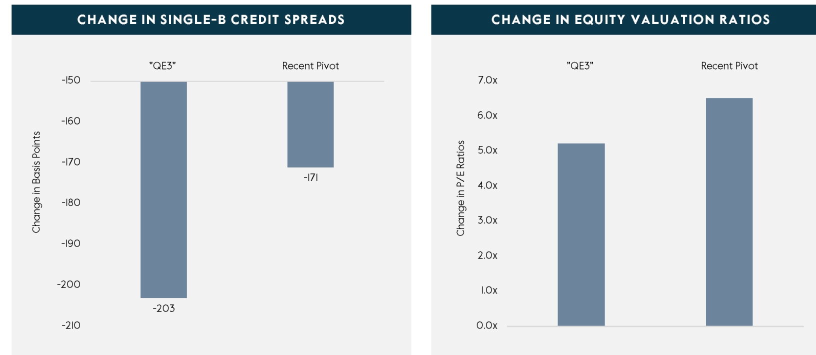
Total Returns vs Risk Compensation

Monthly inflation data do serve as a referendum, of sorts, on whether the stance of monetary policy is really as "restrictive" as policymakers claim. The Fed funds rate currently sits above levels that most analysts would consider necessary to stabilize inflation at full employment. But this metric – an interbank lending rate covering about $80 billion in overnight transactions – tells us little about the broader stance of monetary policy. That was a lesson learned during the "QE era" of 2008-2021, when base rates remained the same but additional

accommodation was delivered through balance sheet expansion and forward guidance.

Most measures of financial conditions – such as that [provided by the Federal Reserve Bank of Chicago] – suggest they've eased materially since the Fed's pivot in Q4-2023. Indeed, the market response to the end of the hiking cycle and promise of future rate cuts has been analogous to that observed during "QE3" in 2012-13 (Figure 3). So, while 5.3% base rates may indeed be "restrictive," the broader constellation of valuation ratios and borrowing costs that light up the Bloomberg Terminal leave a different impression.

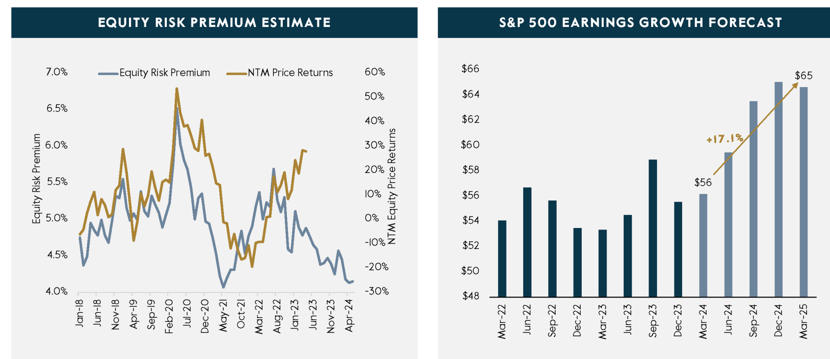
Figure 3: Market Responses, Recent Fed Pivot & QE3



Source: Carlyle analysis of Federal Reserve and S&P Capital IQ data, May 2024. Time period for "recent pivot" is from 10/31/2023 to the trough or peak of spreads and valuations, respectively, post 10/31/2023 (the time of the Fed "pivot"). QE3 occurred over 2012-2013.

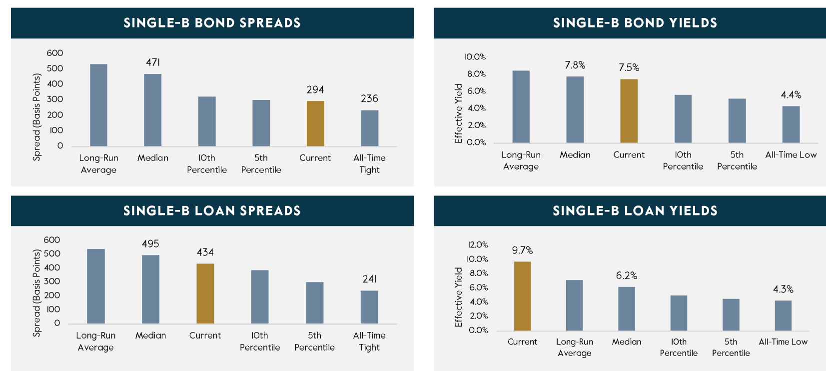
U.S. equity market exuberance can be explained – and potentially validated – by earnings growth (Figure 4). Narrowing credit spreads seem to be the product of investors' focus on total returns. Though single-B bond spreads have declined into the 5th percentile of the historic distribution and just 58bps above all-time tights, all-in yields remain close to their long-term average. Loans look even more juicy, with spreads closer to "normal" levels and effective yields above most asset allocators' long-term equity return targets (Figure 5).

Figure 4: U.S. Equity Market Risk Premia & Earnings Growth



Source: Carlyle Analysis, FactSet, Aswath Damodaran, May 2024. There is no guarantee any trends will continue. No assurance can be given that any projections referenced herein will ultimately materialize.

Figure 5: Credit Investors Focus on Total Returns



Source: Carlyle Analysis; Federal Reserve Board of Governors, Pitchbook LCD, May 2024. There is no guarantee any trends will continue. Average, median, percentile and all-time amounts are based on [U.S.] spreads and yields during the December 1996 – May 2024 period.

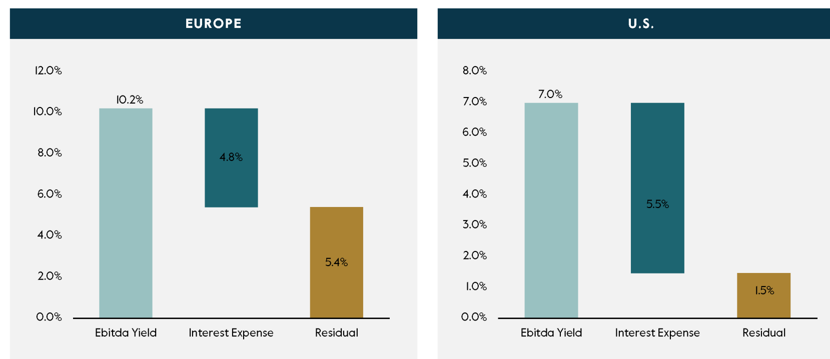
European Value

While the inflation data will provide a sense of whether the Fed might be able to get a rate cut or two in before year-end, the ECB seems prepared to follow the lead of neighbors in Switzerland and Sweden with a cut next month. Easier policy arrives alongside a brightening growth outlook, with improved trends in both official and portfolio company data.

If the relative value of loans looks attractive, that's doubly the case for European assets. Stock valuations sit 30% below U.S. levels, and this differential is even wider when restricting the sample to the small and midcap portion of the market. Stock traders often scoff at such comparisons; assets that look cheap today can stay just as cheap tomorrow. But that cannot be the attitude of buy-and-hold investors, whose total returns depend on the amount of operating cash generated per dollar (or euro) invested.

Lower valuations in Europe translate to 45% more EBITDA per unit of enterprise value than in the U.S. And when accounting for lower borrowing costs, the net cash that flows through to equity holders is over 3.5x higher in a comparably leveraged capital structure (Figure 6). This implies that economy-wide European equity returns can match those in the U.S. with 400bps lower annual earnings growth. With aggregate euro area income growth expected to lag that of the U.S. by less than 100bps annually over the next five years, that's not a high hurdle to clear.

Figure 6: Valuations & Residual Cash Flows



Source: Carlyle; S&P Capital IQ; S&P LCD; Bloomberg, May 2024. Presented for illustrative purposes only. Example assumes a 60/40 debt/equity split; 8% LBO interest rate for Europe, and 9.2% LBO interest rate for the U.S.

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