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Flash Note
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FED rates projections. Implications. Our assessment of Cost of Capital vs Return on Capital

The Market Committee of the FED (FOMC) indicates (through the votes of its members) the following:

- An additional increase in interest rates in December (from the current range of 2% -2.25% to 2.25% -2.50%), with a central point of 2.375% (See Chart 1)
- For 2019, the FOMC signals 3 increases. From an average point of 2.375% at the close of 2018, to an average point of 3.125% at the end of 2019. No change thus, in its forward guidance.
- Looking ahead to 2020, the FOMC signals 1 rate increase. Which means that it continues to see economic expansion until 2021 (which answers many doubts about some recession forecasts).
- In the long term, the FED suggests a natural interest rate of 3%

Positive or negative for equity markets?

Clearly, investors focus is on the Fed rates and it seems as if the current the forward guidance does not please them.

In my view, the true final impact will have to do with the relationship between the COST OF CAPITAL (approximated by the yield deflated in the BBB rated bonds in the US) and the RETURN ON INVESTED CAPITAL (measured by the variation in the real GDP - K.Wicksel proposition).

As a starting point, what we have to know is that the COST CAPITAL for US corporations (2.24%) is still comfortably below the RETURN ON CAPITAL (3.05%), suggesting that the trigger point (turning point) would occur unless an increase in interest rates of 101 p.b takes place, according to our own calculations (see Chart 2).

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Chart 1 -FOMC DOT PROJECTIONS

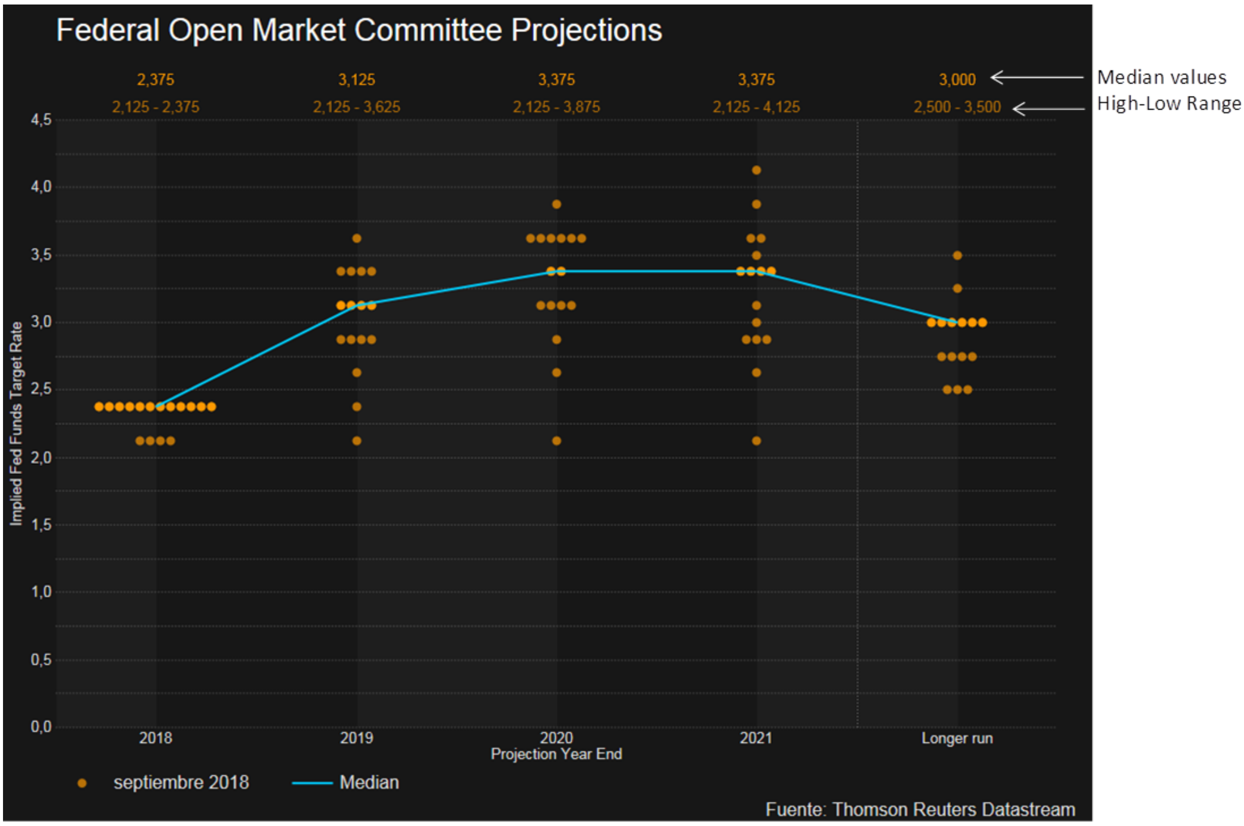

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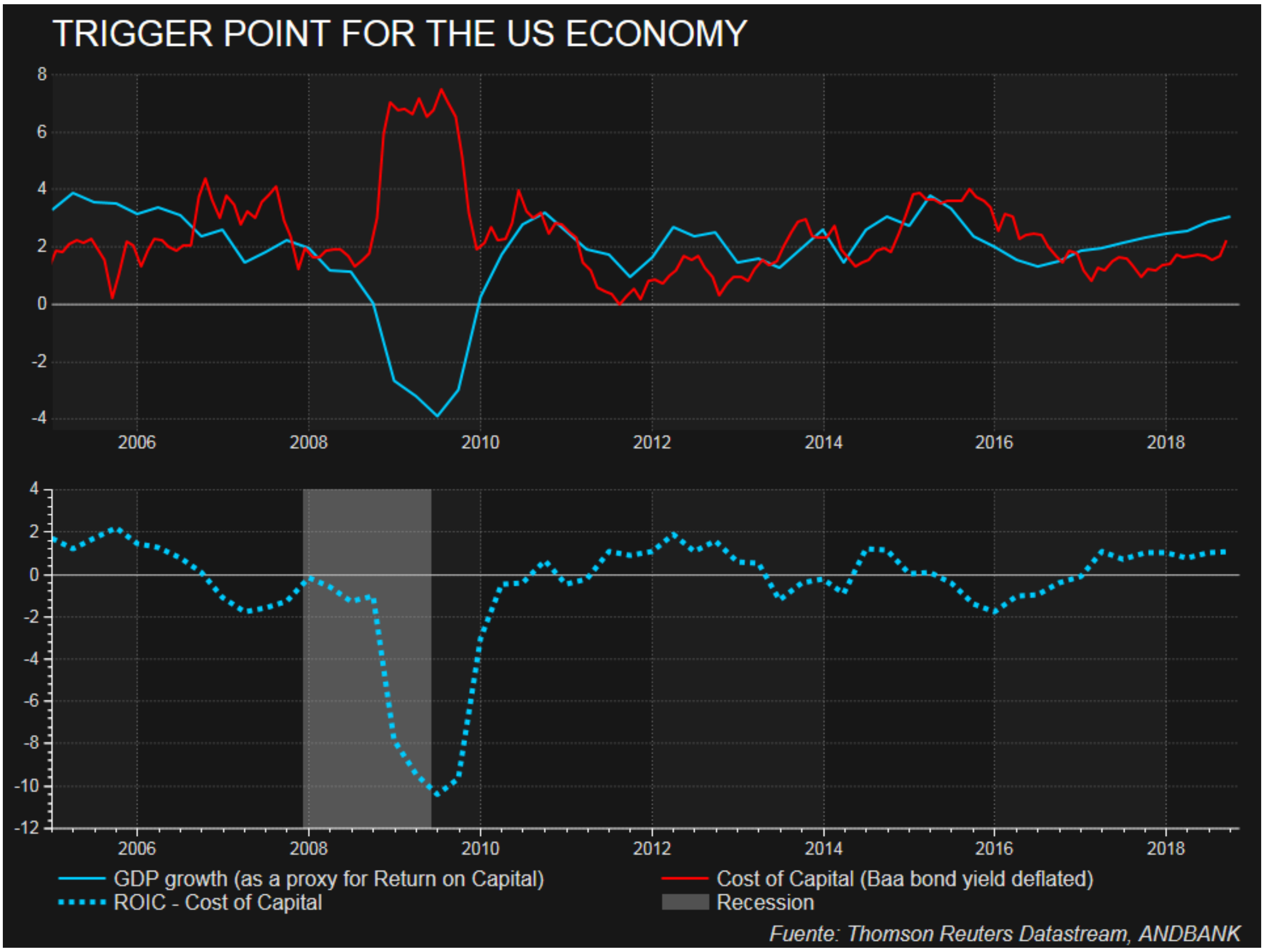
Chart 2 - USA: COST OF CAPITAL vs RETURN ON CAPITAL. (Trigger point)



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