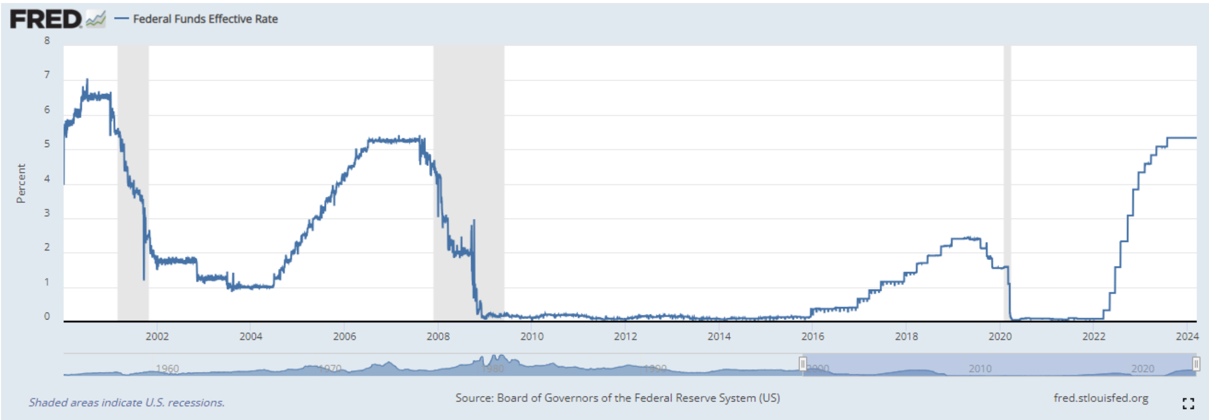
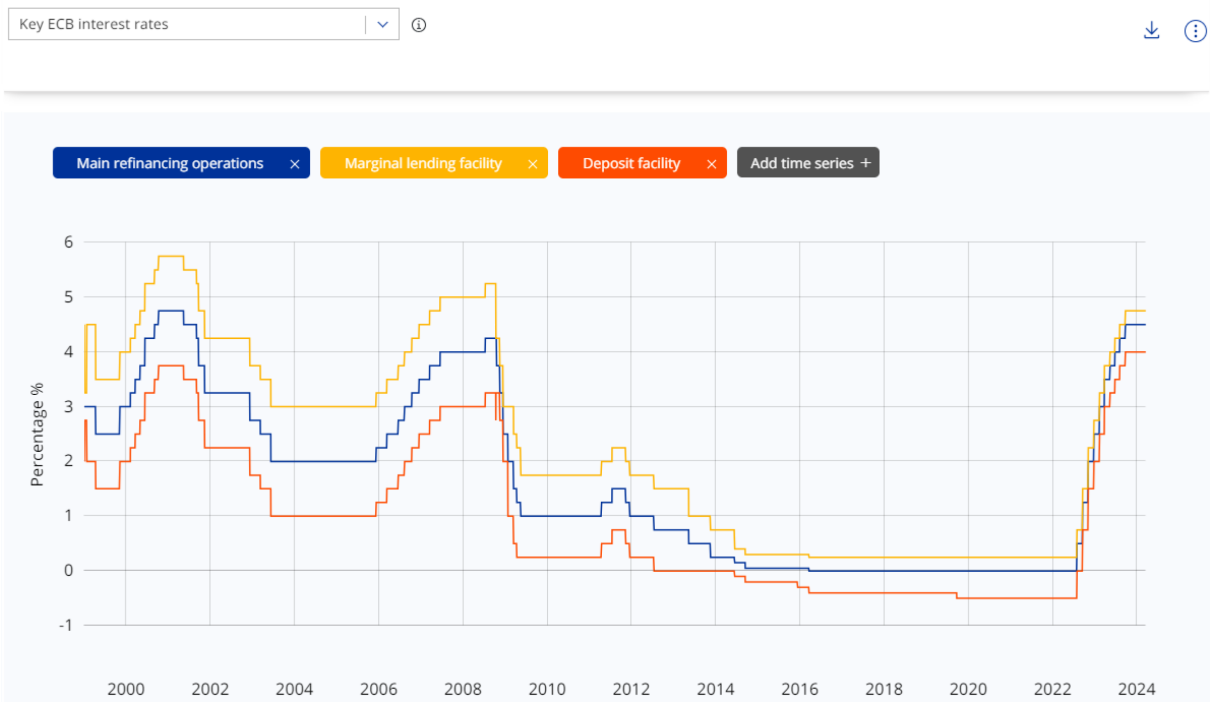
A Macro View

At re:cap we keep abreast with the latest news and developments in the Macro environment. This is of particular importance for the valuation, acquisition, and financing of renewable energy projects. As part of our LinkedIn article series, we wish to share with you some thoughts regarding interest rates in Europe and the US.

The ECB Governing Council and the Federal Reserve decided in March and April to keep their interest rates unchanged at a level of 4.00% – 4.75% in Europe and at a target range of 5.25% – 5.50% in the US[1].





Current market expectations are for a rate cut in the June meeting in Europe and a rate cut in July in the US, with further cuts expected in the second half of this year. Recent language from the ECB[2] suggests that they are looking at the medium-term target of 2%, whilst language from the Fed Committee[3] suggests that rates could be cut once they have confidence inflation is moving sustainably towards the target of 2%. However, a cut before a reduction of inflation below this target seems premature.

US and European central bankers have a mandate, the former the dual mandate of maximum employment and low and stable inflation, and the latter of price stability. The case for central banks to cut interest rates in June or July without having seen consistent inflation below their mandate targets of 2%, be it at the headline or core level, seems like a risky bet. There is a fear in both regions that an easing of monetary policy could cause a flare up in inflation particularly if wage growth stays at its current level.

Cutting rates too soon and allowing inflation to return and then having to raise rates again would destroy the reputation of the current members of the Fed and ECB. No central banker wants to be compared to Arthur F. Burns. A concern on the other side is that the current level of US and European interest rates might cause a crisis related to the commercial real estate exposure of Banks. Related to this is the question of corporate debt maturing in 2024 and 2025.

Jim Bianco, in a recent interview with NZZ[4], mentioned that people might be anchored towards the idea that periods of ultra-low interest rates are normal based on the notion that since the Global Financial Crisis of 2008 and until this last rate hiking cycle that started in 2022 rates had stayed at a quite depressed level in the US and Europe[5]. Given that the Fed rate was on average 5.42% from 1971 – 2024, whilst for the ECB from 1998 – 2024 it stood at 1.8%[5], it seems unlikely that the period of ultra-low interest rates will come back unless something breaks in the economy.

In line with the trend of rising interest rates, we at re:cap have observed a lowering of the Enterprise Value and project right prices, after their highs from 2022 and early to mid-2023. This is mainly due to three factors. Firstly, as the ECB has increased its rates the cost of debt financing has increased. Secondly, as the risk-free rate of return increased, the required total return or return on equity that investors demand from their investments has also increased. Thirdly, gas and electricity prices have decreased and stabilized after their highs caused by the war in Ukraine, albeit at a slightly higher level. Combined, these three factors have had the effect of lowering the prices investors are willing to pay for renewable energy projects. If your cost of debt increases as well as your cost of capital, whilst your short to medium term revenues decrease it seems prudent to change your expectations. re:cap, as an active and long-term asset manager looks at these market dynamics in order to make informed decisions when valuing, acquiring and financing projects.

Citations

[1] https://fred.stlouisfed.org/series/FEDFUNDS#0 & https://data.ecb.europa.eu/data/data-categories/ecbeurosystem-policy-and-exchange-rates/official-interest-rates & https://data.ecb.europa.eu/main-figures/ecb-interest-rates-and-exchange-rates/key-ecb-interest-rates

[2] https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.mp240307~a5fa52b82b.en.html

[3] https://www.federalreserve.gov/monetarypolicy/files/monetary20240131a1.pdf

[4] https://themarket.ch/english/jim-bianco-inflation-fight-may-be-more-challenging-than-people-think-ld.10613

[5] https://tradingeconomics.com/euro-area/interest-rate & https://tradingeconomics.com/united-states/interest-rate

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