Effects of Inflation on the Capital Markets [1]

By: James A Kyprios[2] and Craig Wolson[3]
Originally published at www.securitiesexpert.org on January 26, 2023

Overview

The thesis of this article is simple. We have had 40 years of relative consumer price stability and had thought that inflation was finished. However, we had not taken into consideration the inflation in the capital markets which to some extent was fueled by dramatically lower interest rates[4] over this period. Many in the financial community were referring to "free money". During this period, significant asset inflation especially in equities and in other assets such as real estate contributed to the rising income inequality in the economy. In the credit markets, the long-term decrease in interest rates has resulted in an explosion of debt.

In the last year, we have been dealing with the reappearance of consumer price inflation. The "agreed upon" method of stopping consumer price inflation is by the Fed's tightening monetary policy. Interest rates were drastically increased in 2022. To what extent this will reverse consumer price inflation is not clear, but results in the last five months of 2022 have been quite encouraging. Inflation during the 12-month period ended last summer was over 9%; this has now been decreased to 6.5% for the most recent 12 month period.

What is clear, however, is this: The tightening monetary policy in 2022 has caused a sharp drop in the stock market and led to much less new-issue activity and much less M&A (mergers and acquisition) activity. The tightening has caused interest rates on debt to skyrocket to the point that many borrowers are starting to become problem credits. We have seen in 2022 that the capital markets (primarily debt and equity) have suffered as a result of the Fed's tightening.

---

[1] We wish to thank investment banking expert Bill Purcell (www.purcellbanking.com) for his ideas in helping us write this article.

[2] James Kyprios is an expert in corporate lending and corporate finance. He has over 40 years' experience in corporate finance and banking, was credit- trained at Prudential Insurance Company and has held senior positions at foreign banks in New York. For more information (in particular, information about his experience relating to matters discussed in this article), see Exhibit One at the end of this article and www.kypriosinternational.com.

[3] Craig Wolson is an expert in corporate lending, securitization, and derivatives. He has over 40 years' experience as an attorney specializing in various types of legal documentation of these types of matters. For more information (in particular, information about his experience relating to matters discussed in this article), see Exhibit One at the end of this article and www.structuredfinanceexpert.com.

[4] As Bill Purcell correctly has pointed out: "The growth in the stock market over the years was helped by low interest rates, but also by big technology advances, better management as a result of takeover trends, and large stock buyback programs- all were contributors."

The focus of this article is on the reaction of the capital markets, especially corporate debt, to Fed tightening. The low-interest party is over-- at least until inflation is brought under control. Higher and higher interest rates are deadly to many companies because for too many years, low interest rates allowed (gave permission to) companies to borrow. We have more and more so-called "zombie companies" (companies that don't make enough money even to cover their interest expenses). Higher rates will undoubtedly lead to more defaults and more lawsuits. There may be a recession, perhaps even a serious one.

This is not meant to be a scholarly article. Much of what has been written here is familiar to economists, academics in finance and market participants. It is also common knowledge to many who carefully read the *Wall Street Journal*, the *New York Times*, the *Financial Times* and the *Economist* magazine.Accordingly, we have tried to keep attributions to a minimum.

Distinction between Consumer Price Inflation and Asset Price Inflation

(1) Consumer Price Inflation

Most people reading this article have not experienced consumer price inflation such as that which existed in the1970s. After a 40-year hiatus, this type of inflation came back in 2022. We all know what consumer price inflation is because it affects us at the gas pump and at the grocery store. We remember when inflation of this type reached close to 14%.[5] in 1980. Retired people living on fixed income pensions, then and today, certainly feel the blow of higher prices.

Although he has not been given credit for it, President Jimmy Carter took a big step towards curbing inflation when he named Paul Volker to head the Federal Reserve in 1979. Volker severely tightened the money supply, which led to large increases in interest rates. Eventually inflation was tamed, and by this time Ronald Reagan was President. Over the last 40 years, inflation has been trending downward, as has been the case with interest rates.

Inflation as measured by the Consumer Price Index and the Producer Price Index eventually was reduced to below the 2% threshold that the Fed had targeted. Indeed, in recent years there has been the fear that perhaps there was not enough inflation in the system. From 1980-2021, the inflation rate was about 3%/year.[6] In more recent years, it has been lower. For the 10 years ending in 2021, inflation has averaged below 2% per year.

The super-tight monetary policies initiated by Paul Volker got rid of inflation and removed inflation expectations. In addition, the rise of China and globalism played a key role in the reduction of inflation. Outsourcing of manufacturing to places that have labor costs substantially lower than those in the U.S.

---

[5] Inflation rates were as follows in the late 1970s and early 1980s: 1978-6.8%, 1979-9.3%, 1980-13.9%, 1981, 11.8% and 1982, 8.4%.

[6] https://www.inflationtool.com/us-dollar?amount=100&year1=1980&year2=2021&frequency=yearly

and other highly-industrialized countries has been very important, not only in decreasing prices but also in crippling and even destroying industries and jobs in the U.S. and these other countries.

(2) Asset Inflation

Asset inflation, on the other hand, has been rampant during the last 40 years (prior to Covid). When we think of asset inflation, we usually think of the stock market and also real estate.

From 1980 to March 2022, the S&P500 increased from $133.3 to $41458.18.[7] That is, the stock market increased by 30 times in the last 42 years. Why? A major contributing factor was a steady decrease in interest rates over that period of time. (Other factors accounting for the stock market increase were briefly discussed in footnote 4 at the beginning of this article. However, because we are concentrating in this article on the reaction to inflation by the Fed's increasing interest rates, these other factors are not directly relevant to the following discussion.)

At the beginning of 1980, the Fed Funds rate[8] was 16%; it climbed to a high of 20%[9] within the next year. After that, it steadily decreased to less than 1% (actually close to 0%) as of year-end 2021.

Mortgage rates decreased rapidly during this period. In 1980, fixed- rate mortgage rates kept climbing and reached a high of 16.6% in 1981, the highest such rate in U.S. history. Since that time, mortgage rates began a slow descent; as of March 2022, they were at about 5.4%.

Roughly speaking, there is an inverse relationship between interest rates and asset prices. When rates go down, investors are more likely to put their money into assets that can appreciate such as real estate and the stock market. Asset inflation is "good" for the wealthy who, generally speaking, have money to invest. Asset inflation is not "good" for poorer people, who do not have extra money to invest. Over the last 40 years, it is not surprising that income inequality has increased, disproportionately benefitting the rich. Furthermore, the rich benefit from the fact that asset gains are only taxed when the assets are sold (assuming there are capital gains), and at favorable rates. Dividends on these shares are also taxed at favorable rates.

With respect to housing, the average home buyer had not felt penalized by increasing home prices because significantly lower mortgage interest rates blunted the effect of these increases.

An important point to keep in mind is the role of the credit side of the capital markets. We are talking primarily about loans and bonds. Unlike the stock market, the value of bonds and loans does not keep going up when money is loose. Instead, when the cost of credit goes down, this fuels the financial

---

[7] https://www.multpl.com/s-p-500-historical-prices/table/by-month

[8] The Fed Funds rate is the rate that banks charge when they lend to each other in the U.S. It affects many other interest rate benchmarks in the economy.

[9] https://www.bankrate.com/banking/federal-reserve/history-of-federal-funds-rate/

economy and creates asset bubbles. Reduced rates also create a bubble of too much debt which does not appear harmful when rates are low.

Why Consumer Inflation Has Come Back

Very simply, this is, directly and indirectly, due to the effects of Covid and then the war in the Ukraine. In the early months of the pandemic, the economy was on the verge of collapse; it was saved from another Great Depression by government action. This included Federal Reserve programs in support of the capital markets, including Quantitative Easing (QE). QE is the label associated with Federal Reserve support of the debt markets. QE consists of the Fed's buying bonds regularly in the open market, which has the effect of increasing the money supply and generally loosening monetary policy.

Importantly, the Federal Government passed several massive spending programs under both the Trump and Biden Administrations. The era of big government was back. There was fear among some economists that too much stimulation would lead to inflation; it is obvious in retrospect that this indeed was the case. However, other elements were involved in the rise of consumer price inflation and these are all directly related to Covid and to the war in the Ukraine.

The Causes of Consumer Price Inflation are Complex and the Remedies may be Somewhat Elusive

In traditional economic theory, inflation has often been described as a demand-driven phenomenon. Milton Friedman, the conservative economist, said that inflation is everywhere a monetary phenomenon. In other words, the money supply is too high, and this causes prices to go up. Under the traditional Keynesian model, as espoused by the economist John Maynard Keynes, inflation was the result of an overstimulation of the economy, which showed signs of overheating characterized, for example, by low unemployment rates. Some of Keynes' followers thought that the business cycle could be smoothed out by stimulating the economy in sluggish times and slowing down the economy when the economy was running at full force. There is no consideration in either of these philosophies of supply problems. It was demand that drove the economy. This has always been the predominant view of the economics profession when it comes to inflation. It is a demand problem, and it can be addressed by blunting demand.

In the Keynesian pantheon the cure for consumer price inflation is to increase taxes and/or cut spending. This is a fiscal-policy cure. In the Friedman pantheon, the cure is to decrease the money supply or at the very least temper the increase of the money supply. In the real world, there has traditionally been a combination of fiscal policy and monetary policy solutions utilized to reduce inflation. In more recent years, monetary policy has taken on more prominence to some extent because it is more politically neutral. Fiscal policy requires choices that may be politically unpopular, whereas monetary policy requires actions of the Fed, which are to some extent shielded from politics.

As stated above and described below, Covid and the war have upended these theories, which view the causes and remedies of inflation as demand- related matters. However, supply considerations also enter into the picture. Disruptions of supply basically amount to reductions of supply; we know from

basic economic theory that, when the supply is limited, shortages can and very often do lead to price increases—in other words, inflation.

With this in mind, we now know that the present inflation has been caused by a combination of supply and demand factors all related to Covid and Ukraine war considerations. These are:

- Covid
- The China lockdown
- The Russian invasion
- Loose monetary and fiscal policies

Let's briefly review each of these causes of inflation.
(1) Covid, which began in 2019, has had both domestic and international ramifications. On the domestic front, retail establishments and offices were closed for a very long time. As a result of expansionary policies by government (the Trump and Biden Administrations and expansive actions by the Fed) we avoided an economic catastrophe. Thanks to Zoom, a good deal of business could be done out of the office. However, over one million people have perished as a result of Covid. This and the dislocations in the economy caused by Covid have had an inflationary effect on the economy. In particular, housing and car prices have gone up. From an international point of view, we have seen supply-chain disruptions. All of this has been inflationary. There is very little that the Federal Reserve or the U.S. government through fiscal and monetary policy can do to stop this type of inflation. To repeat, fiscal and monetary policies deal with demand issues, not supply issues. What will get rid of these supply issues is a return to some sort of normality in the real world.

(2) Lock-Down in China. This is one very specific but powerful effect of Covid. We have become so reliant on Chinese supplies that a lockdown on the economy in China has world-wide supply disruption ramifications. This is inflationary. Supply has been severely curtailed. There is little that the President, the Congress and/or the Fed can do about this.

(**3**) **Invasion of the Ukraine by Russia**. Much of the world, especially Europe, has been reliant on Russian oil and gas. The invasion has led to sanctions, which in turn have led to a drastically tightened supply of oil and gas in the world. The oil and gas market is worldwide, and disruptions or reductions in supply lead to large increases in prices, which we have witnessed in the last 12 months. The American consumer felt this first- hand, when prices increased dramatically at the pump. Once more, this is a supply shortage problem outside of our control. President Biden, the Democratic Congress and/or the Fed are not able to control this.

(**4**) The key point to remember is this: loose monetary and fiscal policies have been blamed for the increases in inflation. As we have seen, this is only partially true.

Tools for Controlling Inflation

From a fiscal policy point of view, we can cut the deficit by either increasing taxes or reducing

spending. These steps are politically difficult, especially in today's politically-charged environment. Recently the deficit has been reduced because the economy has been booming, causing an increase in tax receipts.

There are, of course, other tools that the government can use to fight inflation. These can include increasing drilling for oil and even subsidizing key industries. The problem is that these are controversial solutions that may very likely not be politically possible. Another possibility is to reduce or even eliminate tariffs on imports. The Biden Administration has decided not to pursue this approach.

Most economists believe that monetary policy is the best way to tame inflation. They do understand that monetary policy is a very blunt instrument, which can (and often does) cause recessions. This is the price that has to be paid for taming inflation. Chairman Powell of the Federal Reserve has made it very clear in recent statements that his primary concern is taming inflation and inflation expectations. From a monetary policy point of view, the Federal Reserve can tighten up by increasing rates and cutting back and even reversing stimulative policies. Quantitative Easing (QE), described before, has now been replaced by Quantitative Tightening (QT). This consists of the Fed's selling debt instruments into the open market or allowing debt instruments it holds to mature. The result is a reduction of the Fed's monetary reserves which decreases liquidity and money in the financial markets.

When it became obvious that we had an inflation problem, the Fed increased rates. The target rate is the Fed Funds rate, which, as indicated before, is the rate at which U.S. banks lend on a short-term basis to each other. At the beginning 2022, the Fed Funds rate was hovering slightly above 0%. It is now likely to keep being increased until it exceeds 5% in 2023, according to statements from the Fed. The effects of these rate increases have already been felt, as was shown by a precipitous drop in the stock market beginning in the Spring of 2022. Rates on debt instruments, including mortgage rates, increased significantly.

Will the Fed's actions reduce inflation to pre- Covid levels (that is, less than 2%)? Is it possible that some inflation will continue for an interim period? Will there be stagflation[10]? There is no widespread agreement among economists on these matters. A major problem is that the labor market continues to be tight. The latest news indicates very clearly that inflation in the last half of 2022 decreased significantly. However, will consumer price inflation be brought down to the 2% target used by the Fed? The answer to this is not clear as of this writing.

Effect of Tight Money on the Financial Markets

The economist John Kenneth Galbraith once said that financial geniuses are made in rising markets. We all know how well the stock market has done in the last 40 years or so. Less commented on is the fact that declining interest rates have vastly affected the debt markets. We have seen an explosion of debt

[10] "Stagflation" is a term coined in the 1970s and relates to an economy which combines high inflation with low or negative economic growth including a high unemployment rate.

flooding corporate America, with leveraged loans and junk bonds being the norm these days rather than the exception. What happens when interest rates increase by about 400 basis points in less than a year (an increase of four percentage points), as they have recently? More companies will have trouble servicing their debt. This leads to downgrades, including an increase in companies with below-investment-grade ratings and, more dangerously, to an increase in companies that will have to restructure their debt in or out of bankruptcy. Rate increases will lower profitability, will cause further credit-rating reductions and will make it more difficult for companies to access debt and equity financing.

The Fed has Learned from its Experiences in the 1970s and 1980s

What happened in the 1970s and early 1980s? It became very hard for the Fed to control inflation for many years until Paul Volker imposed draconian measures on the economy. It seems that the Fed has learned the lessons from the 1970s and is now fully committed to do what is necessary to end inflation. What is surely different this time as compared to the 1970s is that many, many more companies are highly leveraged than they were some 40 or 50 years ago. There is little doubt that higher rates will have an effect on the credit markets. Over the years, private equity fueled by leveraged finance has become a huge industry. Private equity has been greatly enhanced by low interest rates.[11]

Higher rates now are adversely affecting private equity activity. [12] This includes the high yield (junk bond) market and the leveraged lending markets.

The Fed's basic plan is this: It will keep on increasing rates until it is satisfied that it has inflation under control. At that point it can turn around and reduce rates to mitigate some of the damage. However, this is a tricky business. Some economists as well as Chairman Jerome Powell of the Fed think that the financial markets have been too optimistic in believing that inflation will soon be under control.

In our opinion, it is wise to believe that controlling inflation will not come quickly and that we are in a new world of higher rates for the foreseeable future. Many companies today are highly leveraged. Many companies today have loan and bond agreements with "covenant lite" features. Furthermore, with stock prices under pressure there will be fewer IPOs, fewer mergers and acquisitions and fewer debt financings and refinancings. We anticipate that in the next several years there will be many more distressed situations in the credit markets, ultimately leading to lawsuits.

---

[11] The basic tool of private equity is the leveraged buy out (LBO). Companies are purchased on the basis of the credit worthiness of the target company which is loaded up with debt. When rates are very low, interest expenses are not punitive. However, when interest rates are high, interest expenses become punitive and make it more difficult to "load up" a company with a good deal of debt.

[12] See "**Wall Street's Lucrative Leveraged-Debt Machine Is Breaking Down"** in the January 12, 2023 edition of Bloomberg.com by Lisa Lee, Claire Ruckin and Jill R. Shah:

"Big banks are stuck with about $40 billion of risky debt on their books — blocking the M&A machine that's enriched bankers and private-equity executives over the past decade."

"One of the most lucrative money-making machines in the world of finance is all clogged up, threatening a year of pain for Wall Street banks and private-equity barons as a decade-long deal boom goes bust."

What Might These Litigation Issues entail?

- Corporate lending (either syndicated or direct lending)
- Corporate bond cases
- CLO cases (Collateralized Loan Obligations which now are the primarily investors in leveraged loans)
- ABS (Asset-Backed Securities)
- MBS (Mortgage-Backed Securities)
- Derivatives (especially interest rate swaps or credit default swaps)

These litigation issues could involve agent banks, underwriters, issuers, investors and/or other counterparties. These suits could relate to:

- Inadequate due diligence
- Adequacy or misrepresentation of information supplied
- Securities fraud cases (e.g. failure to disclose material information)
- Libor-transition related issues
- Covenant lite cases
- Situations in which investors relied on credit ratings
- Situations in which the risks of leveraged finance have not been adequately taken into consideration
- Work out and bankruptcy cases
- Whether the risks were fully explained and understood by the relevant borrowers, investors or swap counterparties
- Legal documentation issues
- Legal malpractice issues

Summary and Conclusions

With the re-emergence of inflation, we now are in an environment in which, for the first time in 40 years, interest rates are rapidly increasing. In 2022, the Fed Funds rate increased from about ¼ of 1% to over 4%. It is expected by the Fed that in 2023 the Fed Funds rate will exceed 5%. The effect of this tightening will undoubtedly decrease consumer price inflation. However, it may very well cause a recession and perhaps even a serious one. Higher interest rates will invariably cause an increase in defaults and increases in bankruptcies. Higher interest rates will decrease company profits. Higher interest rates will cause profits to plummet. Higher interest will make it harder for many companies to obtain financing.

The events of the past few years have convinced us that we can no longer rely on crucial and strategic imports from countries like China. We now know that geopolitical risks must be taken into consideration. There will be more products made in America but these will be more expensive. It may be that a 2% per annum inflation rate will not be possible in the near future no matter how tight monetary policy is.

We now appear to be entering into an environment in which higher defaults, more bankruptcies and decreasing profitability will lead to more litigation issues. The days of more troubled credits have begun. High interest rates make it more painful when there is a debt bubble. No one can accurately foresee the distant future. However, it does seem obvious that 2023 will be marked and affected by significantly higher interest rates.

SEE EXHIBIT ONE ON FOLLOWING PAGE

Exhibit One--Examples of Relevant Cases

A main theme in this article is that tight money policies of the Fed to combat inflation are also having a major effect on the capital markets. More problem situations are expected, leading to litigation issues. The authors have the required experience to be of assistance as is documented below.

JAMES KYPRIOS was in charge of corporate finance groups and credit departments and was responsible for rejecting the following credits put together by sophisticated commercial and investment banks:

(1) Well-known gaming project in which the agent bank poorly structured the relevant bonds and failed to do appropriate due diligence.
(2) A refinancing of a major investment bank that went bankrupt in the next year.
(3) The bonds of a highly rated insurance company because the company was primarily investing in junk bonds; when the insurance company went bankrupt, Kyprios was involved in the work out.
(4) A famous clothing retailer because it was growing too fast. The company went bankrupt in the next year.
(5) LBO put together by a well-known M&A Group at a top investment bank. The flaw in the LBO was that debt payment depended to a great extent on the sale of assets and not on projected, predictable cash flow. The LBO was bankrupt in less than a year.

The following are examples of cases in which **CRAIG WOLSON** has acted as an expert witness and/or consultant:

(1) Consultant on a class action for securities fraud involving derivatives
(2) Consultant on a class action against a major bank and numerous large underwriters involving MBS issues
(3) Consultant and potential expert witness for a large investment bank defendant in a case involving CDOs
(4) Consultant and potential expert witness for a hedge fund involving Credit Default Swaps
(5) Expert Witness in a bankruptcy case regarding the issue of a "true sale" of receivables
(6) Consultant and potential expert witness involving legal malpractice of a law relating to CDO issues
(7) Expert witness for defendants who had borrowed money from a bank and in which the bank misled them with respect to a related interest rate swap.