



MORNING BRIEFING

June 19, 2018

Mother of All Credit Bubbles?

See the [collection](#) of the individual charts linked below.

(1) Imaginative bears. (2) Pearlstein's dire prophecy for the "Buyback Economy." (3) Credit bubbles tend to be followed by a crisis, then a contagion, and finally a recession-causing credit crunch. (4) Is corporate debt the epicenter of the next economic and financial disaster? (5) Debt ratios look relatively conservative actually. (6) Corporations have extended the maturities of their debt at record-low interest rates. (7) Buybacks + dividends = 100% of after-tax profits. So what? (8) Retained earnings and buybacks are tiny compared to cash flow from tax-sheltered capital consumption allowance. (9) Capital spending looks normal, not abnormally weak. (10) Corporate credits may be junkier, but don't ignore vultures ready to scoop them up at distressed prices. They may be credit markets' shock absorbers. (11) Melissa does some fact checking on a few of Pearlstein's sources.

Strategy I: The End Is Nearing. While Joe and I find it hard to imagine that a bear market started at the end of January or is imminent, there are a few vocal bears with more imagination than we have. We named three of them last Wednesday. Today, we'll focus on a 6/8 [article](#) in *The Washington Post* ominously titled, "Beware the 'mother of all credit bubbles.'" It was written by Steven Pearlstein, a *Post* business and economics writer. He is also the Robinson Professor of Public Affairs at George Mason University. The article has been "trending," with 555 comments (as of Monday evening) since it was posted on the *Post*'s website. I received several emails from accounts asking me to comment on it. So here goes:

(1) *The end is coming.* I don't disagree with Pearlstein's conclusion: "It's hard to say what will cause this giant credit bubble to finally pop. A Turkish lira crisis. Oil prices topping \$100 a barrel. A default on a large BBB bond. A rush to the exits by panicked ETF investors. Trying to figure out which is a fool's errand. Pretending it won't happen is folly."

I agree that there will be another credit crisis, eventually. In my book, [Predicting the Markets](#), I show that most of the post-war recessions were triggered by rising interest rates. Here is what typically happens: Rising interest rates eventually trigger a financial crisis when some borrowers fail to service their debts at the higher rates. The jump in bad loans forces lenders to cut lending, even to borrowers with good credit scores. The crisis turns into a contagion. A widespread credit crunch and recession result ([Fig. 1](#)). The stock market falls into a bear market ([Fig. 2](#)).

(2) *Corporations will lead the next meltdown.* Pearlstein correctly observes that the previous credit bubble was inflated by "households using cheap debt to take cash out of their overvalued homes." This time, in his opinion, the epicenter of the coming debacle is "giant corporations using cheap debt—and a one-time tax windfall—to take cash from their balance sheets and send it to shareholders in the form of increased dividends and, in particular, stock buybacks." This is where we part ways.

Pearlstein calls it the "Buyback Economy," where future growth is sacrificed for current consumption. The article quickly turns into a liberal progressive rant claiming that corporations are "diverting capital

from productive long-term investment.” Instead, they are engaging in “financial engineering” by converting equity into record debt. And, needless to say, this is all making the rich richer. And who are the rich? Round up the usual suspects: They are corporate executives, wealthy investors and Wall Street financiers.

It's true that nonfinancial corporate (NFC) debt (which includes debt securities and loans) is back near record highs, having risen from \$6.0 trillion at the end of 2010 to \$9.1 trillion during Q1-2018 ([Fig. 3](#)). But NFC liquid assets (\$2.7 trillion during Q1-2018) and cash flow (\$1.8 trillion over the past four quarters) continue to set new highs. The ratio of NFC debt to liquid assets is matching its lowest readings since the mid-1960s ([Fig. 4](#)).

The ratio of NFC short-term debt to total debt has been on a downtrend since the 1980s ([Fig. 5](#)). It is down from 40%-45% during the 1980s and 1990s to roughly 28% during the current economic expansion. This confirms that NFCs have been extending the maturity of their debt to lock in lower interest rates.

(3) *Corporate bond debt at record high.* It is also true that NFC corporate bonds outstanding was at a record high of \$5.4 trillion during Q1-2018, doubling since the mid-2000s ([Fig. 6](#)). But again, this may partly reflect opportunistic lengthening of NFC debt maturities. The spread between gross and net NFC bond issuance rose to a record high slightly exceeding \$600 billion last year ([Fig. 7](#) and [Fig. 8](#)).

(4) *Buybacks are troubling.* Pearlstein claims that buybacks amount to “corporate malpractice,” observing that companies have been spending more than 100% of their net profits on dividends and share repurchases. That's true. However, corporations collectively have always paid out roughly 50% of their profits in dividends, which has never been viewed as malpractice ([Fig. 9](#)).

The sum of buybacks plus dividends has been running around 100% of S&P 500 after-tax earnings ([Fig. 10](#)). That means that buybacks have been 100% funded by retained earnings (i.e., after-tax profits less dividends). Even so, Pearlstein claims with no proof: “The most significant and troubling aspect of this buyback boom, however, is that despite record corporate profits and cash flow, at least a third of the shares are being repurchased with borrowed money, bringing the corporate debt to an all-time high, not only in an absolute sense but also in relation to profits, assets and the overall size of the economy.”

Not so fast: Retained earnings are just one portion of NFC cash flow, which is also determined by the capital consumption allowance (CCA), i.e., depreciation reported to the IRS ([Fig. 11](#)). I like to think of the CCA as a tax shelter for the bulk of the revenues earned by corporations.

(5) *Corporations have been eating their seed corn.* Progressives like Pearlstein are most incensed about how corporations aren't investing in the future. Instead of buying back their shares with 100% of retained earnings and even borrowing to do so, they should be spending more on plant and equipment. They should be paying their workers more and providing them with the skills they need to make their companies more productive, so that real incomes can grow.

What are the facts? The data show that NFC gross capital expenditures are at a record high ([Fig. 12](#)). These outlays continue to be funded predominantly by cash flow in general and the CCA in particular ([Fig. 13](#)). Net fixed investment broadly has matched the spending pattern of the past two expansions ([Fig. 14](#)).

The data also show that net bond issuance has been relatively small compared to cash flow ([Fig. 15](#)). Cash flow has been ample, financing lots of capital spending and share buybacks. So buybacks haven't been at the expense of capital spending. Furthermore, as noted above, corporations have refinanced

and extended the maturities of lots of their debt at lower and lower interest rates ([Fig. 16](#)).

(6) *Corporate borrowing is increasingly risky.* Pearlstein claims: “In recent years, at least half of those new bonds have been either ‘junk’ bonds, the riskiest, or BBB, the lowest rating for ‘investment-grade’ bonds. And investor demand for riskier bonds has largely been driven by the growth of bond ETFs—or exchange traded funds—securities that trade like stocks but are really just pools of different corporate bonds.”

Furthermore, he is troubled that “a greater part of corporate borrowing has come in the form of bank loans that are quickly packaged into securities known as CLOs, or collateralized loan obligations, which are sliced and diced and sold off to sophisticated investors just as home loans were during the mortgage bubble.”

This may be Pearlstein’s most credible concern. Lots of junk has been piling up in the corporate credit markets, just as it did in housing’s subprime credit calamity during the 2000s. However, there was a significant stress test from the second half of 2014 through the end of 2015 in the high-yield market. The collapse of the price of oil caused credit quality spreads to blow out, especially for the junk bonds issued by oil companies. With the benefit of hindsight, that was an amazing opportunity to buy junk bonds.

My working hypothesis is that distressed asset and debt funds with billions of dollars waiting to scoop up distressed assets and debt at depressed prices may mitigate credit crunches. They may be the credit market’s new shock absorber. I believe that’s why the calamity in the oil patch was patched up so quickly without turning into a contagion and a crunch.

(7) *But that’s not all, folks.* At the tail end of his article, Pearlstein covers all the bases with the usual litany of other credit market excesses. Rising interest rates and defaults could send ETF prices into a “tailspin.” The “global economy is now awash in debt.” The US budget deficits will exceed \$1.0 trillion per year on average over the next 10 years. Household balance sheets are in worse shape than widely recognized. Margin debt is at a record high. He does concede that “[While] banks are in better shape than in 2008 to withstand the increase in default rates and the decline in the market price of their financial assets, they are hardly immune.”

Pearlstein deserves credit for cogently presenting the dangers lurking in the credit markets, which have almost always been the epicenter of potential trouble for the economy and the stock market. However, he does so as an alarmist, ignoring lots of evidence that doesn’t support his alarming points. As I observe in my book, “I’ll go out on a limb and predict that there will be another financial crisis in our lifetimes. However, like previous ones, it probably will offer a great opportunity for buying stocks.”

Strategy II: Accentuating the Positives. I asked Melissa to look into a few of Pearlstein’s supporting details. Look, Pearlstein is an experienced financial journalist writing for a reputable publication, so we are not discrediting all of his facts. However, some of the positive developments for NFC debt noted in the reports he cited from the US Treasury, International Monetary Fund (IMF), and Moody’s aren’t mentioned in his article. Trouble may be brewing for NFC debt, but there really aren’t any indications of stress yet. Consider the following:

(1) *US Treasury’s red & green lights.* Pearlstein notes: “‘Flashing red’ is how this buildup of corporate debt was characterized by the U.S. Treasury’s Office of Financial Research [OFR] in its latest annual report on the stability of the financial system.” We agree that it is hard to ignore the red boxes in Figure 20 in the OFR’s [report](#). The red represents high “potential vulnerability” for US NFC credit risk based on corporate leverage ratios, which compare debt to assets and earnings. On the other hand, the same

figure in the OFR report also shows green boxes, which represent low potential vulnerability—i.e., ample ability for US NFCs to cover their interest obligations, based on the ratio of earnings to interest.

The OFR reported: “On the positive side, many companies have rolled over existing debt at lower interest rates, while also lengthening maturities of their debt. These steps make servicing the outstanding debt less costly and boost these companies’ creditworthiness. In 2017, almost 60 percent of high-yield bond deals, by count, included repayment of debt as a use of proceeds. This is the highest level since at least 1995.” The OFR added: “Excluding commodities-related companies, the default rate for non-investment-grade, nonfinancial corporations has held steady at about 2 percent in recent years.”

(2) *IMF’s NFC debt concerns alleviated.* “The International Monetary Fund recently issued a similar warning” about the level of NFC debt, according to Pearlstein. The level of NFC debt may be high; however, one of the IMF’s key findings is that the allocation of corporate credit isn’t nearly as risky as it was before the crisis. In the IMF’s April [Global Financial Stability Report](#), Chapter 2 focuses on the IMF’s new global measure of the riskiness of credit allocation as an indicator of financial vulnerability. The IMF finds that “a period of high credit growth is more likely to be followed by a severe downturn or financial sector stress over the medium term if it is accompanied by an increase in the riskiness of credit allocation.”

The riskiness of credit allocation at the global level has rebounded since its post-global-financial-crisis trough back to its historical average at the end of 2016, observes the IMF. Yet it is not nearly as high as it was when it peaked at the onset of the global financial crisis (see Figure 2.4.1. on page 63 in Chapter 2 of the IMF’s report). “The relatively mild credit expansion in recent years, combined with postcrisis regulatory tightening, contributed to a softer rebound in the riskiness of credit allocation than might be expected given the very loose financial conditions,” explained the IMF.

(3) *Moody’s warning amid current calm.* “Mariarosa Verde, senior credit officer at Moody’s, the rating agency, warned in May that ‘the record number of highly-leveraged companies has set the stage for a particularly large wave of defaults when the next period of broad economic stress eventually arrives,’” observed Pearlstein. Indeed, Moody’s May [report](#) contends that “the non-financial corporate debt burden today is higher than its peak before the 2008-09 financial crisis.” However, Moody’s also finds that “the near-term credit outlook is benign and the speculative-grade default rate remains low.”

CALENDARS

US. Tues: Housing Starts & Building Permits 1.320mu/1.350mu, Bullard. **Wed:** Existing Home Sales 5.520mu, MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: Eurozone Current Account, BOJ Minutes of Policy Meeting, RBA June Meeting Minutes, Draghi. **Wed:** Draghi. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings for these three indexes rose to record highs last week, with MidCap and SmallCap hitting record levels again following a brief pause in early June. Forward earnings activity has been relatively strong in the past 10 months, as LargeCap’s forward earnings has risen in 45 of the past 46 weeks, MidCap’s is up in 41 of the past 42 weeks, and SmallCap’s is up in 39 of the past 42. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap’s forward earnings was steady at 21.3% y/y, which compares to

a seven-year high of 21.7% in mid-May and a six-year low of -1.8% in October 2015; MidCap's dropped to 23.7% from a seven-year high of 24.0%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's eased w/w to 30.2% from a seven-year high of 31.1%, which compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.0% and 9.8%, MidCap 21.3% and 12.6%, and SmallCap 27.4% and 15.3%.

S&P 500/400/600 Valuation ([link](#)): Last week saw forward P/E ratios edge down for these three indexes from 12-week highs, to levels that are not much above their recent post-election lows. LargeCap's weekly forward P/E dropped to 16.5 from 16.6, which is up from a post-election low of 16.0 in late March and down from 18.6 on January 26—the highest since May 2002. That compares to the post-Lehman-meltdown P/E of 9.3 in October 2008, but is well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E fell to 16.7 from 16.8, which is up from its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E had mostly been at or below LargeCap's P/E from August to March for the first time since 2009. SmallCap's P/E edged down to 18.0 from 18.1, which compares to a post-election low of 17.0 in mid-March. That's well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at daily forward price/sales (P/S) ratios, they also improved w/w for all three indexes, but remain at levels well below January highs: LargeCap's P/S of 2.04 is down from a record high of 2.19 on January 26; MidCap's 1.33 compares to its record high of 1.40, also on January 26; and SmallCap's 1.02 is down from 1.05 then, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the books set to close on Q2 results in two weeks, analysts are doing their channel checks and awaiting guidance from the companies they cover. The S&P 500's Q2-2018 EPS forecast was unchanged w/w at \$39.03. That's up 0.1% since the end of Q1, 7.4% ytd, and 8.1% since the passage of the TCJA. The \$39.03 estimate represents a forecasted pro forma earnings gain for Q2-2018 of 20.2%, up a tad from 20.1% a week earlier. That compares to Q1-2018's blended 26.6% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q1, Q2-2018 estimates are higher for six sectors and down for five. Energy's Q2 forecast has risen 12.1%, followed by the forecasts for Real Estate (up 1.7%), Materials (1.3), Health Care (1.1), Tech (0.6), and Utilities (0.3). Consumer Staples is the biggest decliner, with its Q2-2018 forecast down 4.6% since the end of Q1, followed by Consumer Discretionary (-2.0), Financials (-1.8), Telecom (-1.6), Industrials (-1.7), and Telecom (-1.6). The S&P 500's Q2-2018 forecasted earnings gain of 20.2% y/y would be its eighth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q2-2018—with eight rising at a double- or triple-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 20.2%. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q2 relative to very low earnings a year ago, with the pace improving from Q1. The latest forecasted Q2-2018 earnings growth rates vs their blended Q1-2018 growth rates: Energy (141.0% in Q2-2018 vs 86.4% in Q1-2018), Materials (32.5, 39.4), Tech (24.3, 36.5), Financials (21.0, 30.7), S&P 500 (20.2, 26.6), Consumer Discretionary (15.5, 19.6), Industrials (14.8, 24.7), Telecom (13.0, 14.7), Health Care (11.2, 16.3), Consumer Staples (9.7, 12.7), Real Estate (2.3, 3.1), and Utilities (1.1, 16.5). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 16.6% y/y in Q2, down from a blended 24.6% in Q1; that compares to 12.7% in Q4-2017 and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).