



MORNING BRIEFING

October 10, 2018

Looking for Stress Cracks in Corporate Debt

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

(1) Cool-Hand Jay not too worried about NFC debt. (2) Corporate debt rising to record highs, led by bond debt. (3) Corporate cash flow in record-high territory, boosted by depreciation allowance. (4) NFC liquid assets at record high, with or without equity holdings. (5) NFCs have spent the past several years refinancing and borrowing at record-low bond yields. (6) Fed study sanguine about the impact of a 3% federal funds rate on corporate debt. (7) Credit quality is a mounting issue for NFC debt. (8) Are leveraged loans the new subprime problem? (9) Any credit market blowup would be more likely in private lending than public banking, taking down just rates of return, not the financial system.

Corporate Debt I: Staying Calm. Last week, Melissa and I reviewed Federal Reserve Chairman Jerome Powell's 9/26 [press conference](#). He was optimistic about the US economy. He reiterated the Fed's intention to continue gradually raising interest rates.

During the Q&A, Powell was asked if he is concerned about the high levels of nonfinancial corporate (NFC) debt. Powell responded that he sees this as just a "moderate" financial vulnerability. More significantly, from his perspective, "[t]he banking system [has] much higher capital, much higher liquidity, is much stronger." In other words, any problems caused by NFC debt aren't likely to become systemic ones for the banks, which the Fed supervises and regulates.

In our opinion, there are also other reasons not to worry too much about this issue. True, US NFCs' debt is at a record high and well above where it was before the 2008 financial crisis. So investors are right to wonder whether servicing it will become too onerous for US companies as interest rates rise. But many firms have refinanced their debt with longer maturities at the historically low interest rates of recent years. We conclude that interest costs will continue to be manageable for firms across most sectors, for reasons discussed below—including the fact that corporate earnings, cash flow, and liquid assets are at record highs and likely to move still higher.

Let's have a closer look at NFCs' income statements and balance sheets with the help of the Fed's latest [Financial Accounts of the United States](#), which recently was updated through Q2-2018:

(1) *Corporate debt at record highs.* NFC debt (which includes debt securities and loans) is at a record high, having risen from \$6.0 trillion at the end of 2010 to \$9.4 trillion during Q2-2018 ([Fig. 1](#)). Over that same period, the outstanding value of NFC bonds rose \$2.1 trillion to a record \$5.4 trillion ([Fig. 2](#)). At \$3.2 trillion, NFCs' bank loans exceeded their previous record high posted just before the 2008 financial crisis.

(2) *Corporate cash flow at record high.* Both NFC cash flow and liquid assets also continue to set new highs. The four-quarter sum of total internal funds including the Inventory Valuation Adjustment (which removes inventory profits and losses) remains in record-high territory at \$1.9 trillion ([Fig. 3](#)). The latest reading, for the four quarters through Q2-2018, received a big boost from the Capital Consumption

Allowance (a.k.a. depreciation expense), which increased 15.4% y/y to a record \$1.6 trillion. Providing a big boost to this major component of cash flow was the tax bill enacted at the end of last year. It [increased](#) the rate of bonus depreciation (which allows an immediate first-year deduction on the purchase of eligible business property) to 100% for 2018 until 2023.

(3) *Liquid assets at record high.* Liquid assets held by NFCs was recently redefined by the Fed to include equities and mutual fund shares ([Fig. 4](#)). The total was little changed near Q4's record high, at \$4.4 trillion, during Q2-2018. Excluding equities and mutual fund shares, it was \$2.2 trillion. We prefer the old measure since during periods of financial stress, the value of equities often dives. Measured either way, however, the ratios of NFCs' debt to liquid assets have remained relatively low by historical standards ([Fig. 5](#)). That's also true for the ratios of NFCs' short-term debt to liquid assets measured either way ([Fig. 6](#)).

(4) *Extending maturities at lower rates.* The ratio of NFCs' short-term debt to total debt has been on a downtrend since the mid-1980s. It is down from 40%-45% during the 1980s and 1990s to roughly 28% during the current economic expansion ([Fig. 7](#)). This confirms that NFCs have been extending the maturity of their debt to lock in lower interest rates ([Fig. 8](#)).

Furthermore, the spread between gross and net NFC bond issuance rose to a record high, exceeding \$600 billion during the four quarters through Q2-2018 ([Fig. 9](#) and [Fig. 10](#)). That certainly implies lots of refinancings. Interestingly, net issuance has dropped 65% since peaking at \$462 billion during Q3-2015. It is now the lowest since Q3-2011. The tax reform act at the end of last year may have reduced the tax benefit of raising money in the bond market. Increased regulation in the public markets following the crisis may have pushed financing into the private markets, as discussed below.

(5) *Buybacks not at the expense of capex.* Progressives have argued that corporations are not making productive use of their resources. They say that firms are using borrowed funds for share buybacks rather than investing in future earnings potential. But the data show that NFCs' capital expenditures are at a record high ([Fig. 11](#)). The data also show that net bond issuance has been relatively small compared to cash flow ([Fig. 12](#)). There has been plenty of cash flow to finance both capital spending and share buybacks.

Corporate Debt II: Fed Does Hypothetical Stress Test. In an 11/15/17 [study](#) titled "The Potential Increase in Corporate Debt Interest Rate Payments from Changes in the Federal Funds Rate," Fed researchers analyzed the aggregate impact on NFCs' debt burden of an increase in the federal funds rate to 3.00% by 2019. We reached out to ask whether they had an update and learned they're considering working on one. Let's go with last November's analysis for now because the federal funds rate assumption isn't far from where we expect the rate to be by year-end 2020 and we think the study's conclusions still apply.

The Fed researchers found that the aggregate interest coverage ratio (the ratio of EBIT to interest expenses on bonds and loans) for US NFCs would decline in 2019 from 4.6 in a scenario in which rates remain at current levels to 4.1 in a scenario in which rates rise to 3.0%. The researchers qualified that burden as "modest" and explained that it is not evenly distributed among sectors. They concluded that "significant vulnerabilities to higher rates appear to be restricted to the real estate sector, mostly because of the large fraction of floating-rate debt in that sector."

Corporate Debt III: Real Stress Tests Ahead? The reasons not to worry about NFC leverage are compelling. But we have a couple of caveats: One is that the aggregate data do not reflect the distribution of cash among nonfinancial corporates; the other is that the aggregate data do not reflect the mix of debt maturities or credit ratings. While we give some weight to these qualifications, we doubt

that the credit markets are headed for doomsday unless a severe US economic downturn occurs. Let's discuss:

(1) *Top cash holders removed.* In our 7/3 [Morning Briefing](#), we covered a 6/26 [report](#) by S&P Global. It observed that removing the top 25 cash holders from the cash-to-debt equation paints a more sobering picture than the data for all the corporations that S&P Global analyzed. According to S&P Global, "More than 450 investment-grade companies that aren't among the top 1% have cash-to-debt ratios more similar to those of speculative grade issuers than to those in the top 1%." Sure, that's concerning. But for now, NFCs across most sectors have enough earnings to cover their interest expenses even if rates rise, as the Fed study found.

(2) *Lots of BBBs.* S&P Global's observation was picked up by an 8/17 *Barron's* [article](#), which was referenced in a 10/5 *Barron's* [article](#). The 10/5 article quoted our friend David Rosenberg, chief economist and strategist for Gluskin Sheff, who wrote: "One could be forgiven for wondering aloud about how rising interest rates in the most leveraged economy of all time, with over half the \$6 trillion investment-grade corporate bond market now rated BBB (and a tsunami of refinancing due in the next three years), will play out from a default perspective."

We can't help but wonder along with Rosenberg what would happen if these bonds, just a step above junk, were to be downgraded. Large institutional investors that are allowed to hold only investment-grade debt would be forced to sell. But that scenario isn't likely to play out if the US economy continues to expand, earnings continue to grow, and interest costs remain coverable.

(3) *Not maturing so fast.* But the dollar amount of BBBs out there could become a serious problem if any of those dynamics change. A downgrade cycle could worsen the pressure from all the bonds up for refinancing over the next few years, as Rosenberg observed.

Roughly 20% of outstanding NFC bonds will come due during 2021 to 2022, according to data from the Mergent's Fixed Income Security Database used in the Fed analysis. The good news (for now) is that slightly more than 40% of these bonds don't mature until after 2024. However, the mix of maturities is skewed earlier for speculative-grade (about 30% mature in 2021 to 2022) than investment-grade (about 15%) NFC bonds.

Corporate Debt IV: Private vs Bank Lenders. On the subject of potential doomsday scenarios, some say that the types of risky loans that blew up during the financial crisis haven't gone away. Instead, they have been transferred from (now) highly regulated bank lenders to nonbank lenders that are not held to the same scrutiny, or transparency. The concern is that nonbank lending could pose a systemic risk to financial stability.

Lots of risky private loans are being bundled into financial products reminiscent of the collateralized loan obligations that severely worsened the financial crisis. In the search for yield following the crisis, lots of pension funds have bought these loans. Banks are still indirectly involved with these loans, lending funds to the private firms that repackage them.

If these nonbank loans implode, it may reduce the rates of return realized by the institutional portfolios that own them. But since bank capital is highly regulated and well monitored these days, it probably isn't vulnerable to significant hits as it was during the crisis. Keep in mind too, as discussed above, that corporate bonds compose the majority of the NFC debt market whereas corporate loans represent a smaller share.

The bottom line is that we don't think that there is a big failure issue. But our lingering concern is the

risk that we can't see. Nonbank lending isn't nearly as transparent as bank lending. Covering the issue from both sides, the 4/10 *WSJ* included an [article](#) titled "Big Banks Find a Back Door to Finance Subprime Loans." Here are some of the key points:

(1) *Indirect lending*. Bank loans to nonbank financial firms have increased "sixfold between 2010 and 2017 to a record high of nearly \$345 billion, according to a *Wall Street Journal* analysis of regulatory filings. They are now one of the largest categories of bank loans to companies."

(2) *Better structure*. "Banks say that this time around they have figured out how to structure the credits to avoid problems." Banks typically "require the nonbanks to commit the loans they make as collateral for the bank loan. And they will only lend the nonbanks an amount equivalent to a portion of the collateral." That means that "a much higher-than-expected share of the loans would have to go bad for the bank to lose money."

(3) *Manageable exposure*. During 2016, "officials from the Office of the Comptroller of the Currency reviewed the exposure at more than a dozen banks." Regulators "looked at the types of nonbanks the banks were lending to, whether those loans were properly secured by collateral and whether there were any concentrations of risk ... At the time, the OCC found the exposure manageable."

CALENDARS

US. Wed: PPI-FD Headline, Core, and Core Less Trade Services 0.2%/0.2%/0.2%, Atlanta Fed Business Inflation Expectations, Wholesale Trade Inventories 0.8%, MBA Mortgage Applications, Evans, Bostic. **Thurs:** Headline & Core CPI 2.4%/2.3% y/y, Jobless Claims 207k, Treasury Budget \$62.0b, EIA Natural Gas Report, EIA Petroleum Status Report. (Econoday estimates)

Global. Wed: UK GDP 0.1%/m/m/0.6%3m/3m, UK Headline & Manufacturing Industrial Production 1.0%/1.1% y/y, UK Trade Balance -£1150, China Aggregate Financing, China New Yuan Loans 1340.0b, Japan Machine Tool Orders. **Thurs:** BOE Credit Conditions & Bank Liabilities Surveys. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): All these indexes were at record highs at the end of August for the first time since January as SmallCaps were outperforming LargeCaps and MidCaps on a ytd basis. However, SmallCaps have struggled mightily since then, and LargeCaps have closed the performance gap. Here's how they rank ytd through Monday's close, along with their percentage changes since their record highs in August and September: S&P SmallCap 600 (9.0% ytd, -7.1% from record high), S&P LargeCap 500 (7.9, -1.6), Russell LargeCap 1000 (7.6, -1.9), Russell SmallCap 2000 (6.1, -6.4), and S&P MidCap 400 (3.5, -4.0). Forward revenues and earnings are at record highs now for all the S&P and Russell indexes. 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 22.8% y/y. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change dropped to 23.4% from 23.5% a week earlier, down from mid-September's 24.1%, which had been the highest since April 2011 and compares to a six-year low of -1.3% in December 2015. SmallCap's rose to an eight-year high of 35.3% from 34.2% the week before, which compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: S&P LargeCap 500 (22.6%, 10.3%, 9.7%), S&P MidCap 400 (21.3, 12.3, 11.0), and S&P SmallCap 600 (29.9, 15.2, 12.0).

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth index is up 13.2% ytd, well ahead of the 2.3% gain for its Value counterpart. Value is 3.5% below its January 26 record high and no longer in a correction, while Growth is 1.7% below its record high on October 1. During 2017, Growth's 25.4% gain was double the 12.6% rise for Value. Growth had trailed Value in the four months following the election. Now Growth's 44.5% gain since the election is nearly double the 23.9% increase logged by Value. During 2016, the S&P 500 Growth index had underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver more than double the rate of revenue growth (STRG) that Value does over the next 12 months, but forward earnings growth (STEG) is only slightly higher for Growth; specifically, 8.5% STRG and 13.4% STEG are projected for Growth, respectively, vs 4.5% and 11.8% for Value. Prior to February's selloff, Growth's P/E of 21.8 on January 26 was its highest since May 2002, while Value's 16.6 on January 3 was its highest since April 2002. Through Monday, Growth's P/E was back up to 19.8 from its 15-month low of 18.8 on April 2, and Value's 14.2 remains close to its 25-month low of 13.9 on March 23. Regarding NERI, Growth's was positive in September for a 17th straight month, and edged up to 8.9% from 8.8% in August; that compares to a record high of 22.3% in March and a five-year low of -16.2% in April 2015. Value's NERI was also positive in September for a 17th month (following 33 months of negative readings), edging up to 5.3% from 5.1%; that compares to a record high of 21.2% in March and five-year low of -20.3% in April 2015. The Tax Cut and Jobs Act (TCJA) has boosted the consensus 2018 earnings estimate and the forward profit margin for both Growth and Value. Growth's 2018 estimate has risen 9.7% vs Value's 8.8% gain. Growth's forward profit margin has jumped to 16.5% from 14.4% prior to the TCJA's passage, and is down slightly from its record high of 16.7% during mid-September. Value's forward profit margin of 10.1% now matches its pre-financial-crisis record high during August 2007 and is up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): "This is the longest streak of small business optimism in history, evidence that tax cuts and regulatory rollbacks are paying off for the economy as a whole," said NFIB President and CEO Juanita D. Duggan. "Our members say that business is booming and prospects continue to look bright." The NFIB Small Business Optimism Index (SBOI) continued its historic 23-month positive trend, with a reading of 107.9 in September—the third-highest reading in the survey's 45-year history; August's was the highest, at 108.8. The SBOI is up 13.0 points since just before the November 2016 election. Last month, of the 10 components of the SBOI, six decreased, three increased, while current job openings was unchanged at its record high. While some components took a step back last month, the NFIB reports that small businesses so far this year have produced 45-year record-high measures of job openings, hiring plans, actual job creation, compensation increases (actual and planned), profit growth, and inventory investment. NFIB's Chief Economist Bill Dunkelberg added his two cents, warning "With profits and investment remaining strong, our hope is that policymakers will stay the course and not screw around with success."

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