Corporate Debt Bombs?

See the collection of the individual charts linked below.

(1) Record nonfinancial corporate debt. (2) Revisiting the bubble question. (3) Alarming headlines not supported by actual stories. (4) Yellen and Warren both worrying about CLOs. (5) Fed Governor’s lame response. (6) Meanwhile, the US economy continues to have the pedal to the metal. (7) “We bring good things to life”: GE dropped its famous slogan in 2013, and now is on life support. (8) Defaults remain low thanks to previous refinancings at low interest rates. (9) AA-rated CLOs have a solid credit history. (10) Distressed asset funds are the credit markets’ shock absorber.

US Economy: Land Mines in the Corporate Debt Market? Debt owed by nonfinancial corporations (NFC) is at a record high, according to the latest (9/20) Financial Accounts of the United States compiled by the Fed. It rose to $9.4 trillion during Q2 (Fig. 1). This total includes $5.4 trillion in bonds and $3.2 trillion in loans (Fig. 2).

Is this the next bubble to burst, causing the next financial contagion and recession? Each time that Melissa and I have considered the question, we have come to the same conclusion: While there may be reasons to worry about a possible bubble in the NFC debt market, we aren’t overly concerned. (For more, see our 6/19, 7/2, 7/3, and 10/10 Morning Briefings.)

But the story isn’t going away. Last week, the subject made for especially good media fodder for a relatively slow holiday news week. There are mounting worries that the Federal Reserve, by raising interest rates, is steadily eroding companies’ ability to service swollen debt levels. That could turn into especially bad news if the US economy weakens, further squeezing corporate profit margins and depressing cash flow. Nevertheless, we think that most of the debt outstanding should continue to be manageable for firms.

CNBC’s Jeff Cox is a very thorough reporter, and he wrote a very balanced 11/21 article on this subject. It wasn’t alarmist at all, suggesting that the outlook remained fairly bright for corporate credit. Yet his story was titled “A $9 trillion corporate debt bomb is ‘bubbling’ in the US economy.” We are assuming his editor decided the article would attract more readers if the title implied that there’s a big bomb in the credit markets. Given the traumatic impact of the last financial crisis, it’s easy to scare people into thinking that a repeat of the calamity, perhaps one that’s even worse than the last, is on its way.

Of particular concern are collateralized loan obligations (CLOs). The Fed’s quarterly data show NFC loans at depository institutions and those not classified elsewhere. Presumably, the latter category counts loans made by the shadow banking system including CLOs. During Q2, NFCs’ bank loans rose $54 billion y/y to a record $1.1 trillion (Fig. 3). NFCs’ other loans jumped $267 billion y/y to a record $1.5 trillion.

“I am worried about the systemic risks associated with these loans,” said former Fed Chair Janet Yellen
in a 10/25 interview with the Financial Times. “There has been a huge deterioration in standards; covenants have been loosened in leveraged lending,” she added. Yellen suggested that the US needs to focus on fixing weaknesses in the system rather than going in a “very deregulatory direction.”

Her main concern is that while banks may be well capitalized against leveraged loans, the debt is being repackaged and sold elsewhere. She added: “If we have a downturn in the economy, there are a lot of firms that will go bankrupt, I think, because of this debt. It would probably worsen a downturn.”

Senator Elizabeth Warren (D-MA) echoed Yellen’s remarks during an 11/15 congressional hearing. “The Fed dropped the ball before the 2008 crisis by ignoring the risks in the subprime mortgage market,” Warren said. “What are you doing differently this time in coordination with other federal regulators so that you’re limiting the risk that leveraged loans cause serious harm to the financial system?”

Warren addressed her question to Fed Governor Randal Quarles, vice chairman for supervision and thus the central bank’s leading bank regulator. He responded rather lamely, saying that banks received “guidance” on the issue several years ago and that it’s not the central bank’s duty to “enforce” something that was not codified as a rule. “We are holding them to standards of safety and soundness,” he said. “We are not in any way abrogating or not looking at leveraged lending.”

Are there really bombs in the debt markets? Before we address this question in the following three sections, let’s review some of the economic indicators confirming that the US economy remains strong and that, while corporate profits growth is bound to slow, it will do so as it continues to rise to record highs. Consider the following:

(1) **Truck tonnage and railcar loadings.** During October, the ATA Truck Freight Index soared 9.5% y/y to yet another record high (Fig. 4). There’s no sign that a shortage of truck drivers is hampering the trucking industry from delivering the goods. Similarly, intermodal railcar loadings soared to a record high in the 11/17 week (Fig. 5). The y/y growth rate of this series (using the 26-week average) is highly correlated with the comparable growth rate in industrial production. The former is up 4.4%, while the latter rose 4.1% during October.

(2) **Regional business surveys.** So far, November regional business surveys are available for four Fed district banks. The average of their composite business indicators fell during November, but remained around the elevated levels since Election Day 2016 (Fig. 6).

(3) **Forward revenues.** S&P 500 forward revenues rose 9.7% y/y to yet another record high during the 11/15 week (Fig. 7). This weekly series, reflecting industry analysts’ consensus expectations, is a very good coincident indicator of actual quarterly S&P 500 revenues, which may be rising to yet another new record high during the current quarter.

**Corporate Debt I: Record Bond Debt Poses Some Risk.** Is there a bomb in the NFC bond market ready to go off? We’re now seeing “some spreads widening, which will be more impactful on high yield. We could see triple-B credits, some of them, move from investment grade to high yield,” George Rusnak, co-head of Global Fixed Income for the Wells Fargo Investment Institute, was quoted as saying in the 11/21 CNBC article cited above. Let’s consider this and other reasons to worry and not to worry about the corporate bond market:

(1) **BBBs could go south.** One current high-profile case of the BBB downgrade threat is General Electric, which is bordering on junk status. Some say GE’s problem is idiosyncratic. Others say that it is reflective of a wider corporate debt problem, as an 11/26 CNBC article discussed. If the
creditworthiness of BBBs sours, especially high-profile ones, that could create a downward spiral where investors start demanding higher yields to offset the risk of downgrades.

(2) **Defaults low.** Despite the level of corporate debt and the risks presented, the credit market has performed well, CNBC’s 11/21 article observed—that is, other than some “turbulence” in the energy sector from late 2015 to 2016. For 2019, Fitch Ratings expects bond defaults to be the lowest since 2013. Eric Rosenthal, Fitch’s senior director of US Leveraged Finance, said that he isn’t worried about “systemic” risk caused by the corporate debt load now.

(3) **Deceiving debt ratios?** Total NFC debt (including debt securities and loans) is at a record high. But it is also notable that the liquid assets (excluding equities and mutual fund shares) position held by NFCs is strong. The ratio of NFCs’ total debt to liquid assets (excluding equities and mutual fund shares) has remained low by historical standards (Fig. 8).

However, the top companies may skew these data. S&P Global reported that US companies were holding about 33% in cash relative to debt as of mid-2018. But most of that cash is held by large corporations, noted a 9/12 CNBC article. The article on GE noted that about eight companies hold the bulk of that cash. The cash-to-debt ratio of speculative-grade borrowers reached a record low of 12% in 2017 compared to 14% during 2008, according to S&P Global.

(4) **Tax-cut cushion.** It was nearly a year ago that corporations received a big tax boost from the Tax Cuts and Jobs Act, which slashed the federal statutory corporate tax rate to 21% from 35%. Since the tax cut took effect, according to data from Moody’s Investors Service, the top 100 NFCs have contributed $72 billion of new cash flows to pay down debt. That is just slightly less than $81 billion transferred to shareholders through buybacks and dividends, reported the 11/21 CNBC article.

So companies are spending “a much larger percentage of incremental dollars on debt reduction,” Moody’s said in a report, according to CNBC. “What we see when we look at the annual net borrowing activity is a big swing from issuers changing from a net borrower each year pre-tax overhaul to a net-payer of debt post-tax overhaul.”

(5) **Comfort in refinancing.** Many firms have been refinancing their debt with longer maturities at the historically low interest rates of recent years. 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. 9).

Further implying lots of refinancing activity, 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. 10). Interestingly, net issuance has dramatically dropped 65% since peaking during Q3-2015 and 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 financial crisis of 2008 may have pushed financing, especially for leveraged lending, into the shadow markets, as discussed below.

**Corporate Debt II: CLO Risk May Be Overblown.** The value of the US leveraged loan market has doubled in the past six years to $1.1 trillion, according to an article in the 10/2 Financial Times and S&P Global Market Intelligence. Leveraged loans are debts from non-investment-grade borrowers.

Leveraged loans underlie collateralized loan obligations (CLOs), which are structured similarly to the mortgage lending instruments that blew up during the financial crisis, i.e., collateralized mortgage
obligations (CMOs). Let’s review the risks and risk-mitigating factors associated with these products:

(1) **Risky loans repackaged.** CLOs purchase a diversified pool of senior secured bank loans made to companies, which are typically rated below investment grade. CLO debt is divided into tranches, each of which has a unique risk/return profile. “Just because leveraged loans get packaged into CLOs does not make risk disappear. The credit risk of these loans is simply being transferred to the CLO holders,” *Forbes* contributor Mayra Rodriguez Valladares noted in an 11/5 article.

(2) **Heavy on cov-lite.** The value of CLOs has increased by about 130% from the start of 2008 through Q3-2018 to $600 billion, the article observed, with over 70% of those loans covenant-lite.

(3) **Not riskier per-se.** On the other hand, a “covenant-lite loan isn’t necessarily riskier just because it is light on covenants, and it will not be the single determinant of losses in the next credit downturn. Other relevant considerations such as the quality of the capital structure, financial health of the enterprises, and the ability of the sponsor to [recapitalize] the company are necessary to determine the riskiness of a loan,” argued an op-ed letter in the 5/9 *Financial Times*.

(4) **Once again, defaults low.** One reason not to worry about CLOs today is that they are structured in a much more “plain-vanilla” fashion than the instruments that worsened the financial crisis, as we detailed in our 7/2 Morning Briefing, linked above. Further, while CLOs have a bad reputation, those rated AA or above never experienced a default even during the financial crisis, as we have previously discussed. For 2019, Fitch Ratings expects leveraged loan defaults to be the lowest since 2011.

**Corporate Debt III: Distressed Asset Funds to the Rescue.** Bloomberg reported in a 7/10 article that Morgan Stanley data indicates that corporate debt breaks down to 34% (high-grade bonds), 34% (BBB bonds), 16% (high-yield bonds), and 16% (leveraged loans). Let’s assume that this mix hasn’t changed much in 2018. That breakdown was characterized as alarming in the article. However, our take is less so.

For starters, we can safely set aside investment-grade debt (34% of NFC debt), because the likelihood of default there is low. High-yield bonds (16%) can also be put aside, as the investors in this debt presumably are well informed of the risk involved and receiving commensurate compensation. It’s the negative surprises that could cause the most pain in the corporate debt market, so let’s focus where they could happen:

(1) **BBBs.** Indeed, BBBS (34%) may be susceptible to downgrades and defaults, but not all BBBs. PIMCO estimated back in January that about $80 billion in BBB-rated bonds potentially could be downgraded in 2018. Assuming that as a ballpark would put potentially troublesome BBBS at a very small percentage of the total triple-B market and a miniscule fraction of overall NFC debt.

By the way, GE carries a total debt load of about $122 billion, according to an 11/20 *WSJ* article. Bloomberg reported in a 10/2 article that the company decreased its total debt by around $300 billion since the end of 2010 through the end of June. An 11/26 Seeking Alpha blog post noted some good reasons why GEs problems may be self-inflected and isolated.

(2) **CLOs.** The concern with leveraged loans (16%), as discussed above, is that a large percentage of these are cov-lite. That potential risk may not be so transparent to the ultimate buyers of the structured products composed of these risky loans. While sizable, however, leveraged loans represent the smallest share of the US corporate lending pie. CLOs now compose about 60% of the $1 trillion leveraged loan market,” reported the 6/26 *WSJ*. 
(3) **Shock absorber.** But what if some share of NFC debt unexpectedly goes bust? As I wrote in the 6/19 *Morning Briefing:* “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.”

Bargains scooped up by these distressed asset funds, of course, expose someone to big hits. This time, it probably won’t be the banks. More likely, the losses will simply reduce the rates of return among some large institutional investors and perhaps some bond funds (including exchange-traded funds), ending there. In other words, the odds of a systemic calamity like we saw in 2008 remain low, in our opinion.

**CALENDARS**

US. **Tues:** Consumer Confidence Index 136.9, S&P Core Logic Case-Shiller HPI 0.3%m/m/5.3%y/y, Clarida, Bostic, George, Evans. **Wed:** Real GDP & PCE 3.5%/3.7%, GDP Price Index 1.7%, Corporate Profits, Richmond Fed Manufacturing Index 15, Merchandise Trade Balance Advance Estimate - $76.8b, New Home Sales 575k, MBA Mortgage Applications, EIA Petroleum Status Report, Powell. *(Econoday estimates)*

Global. **Tues:** Germany Retail Sales. **Wed:** Japan Retail Trade 0.5%m/m/2.7%y/y, BOE Financial Stability Report & Stress Test Results, Banxico Inflation Report. *(DailyFX estimates)*

**STRATEGY INDICATORS**

**S&P 500/400/600 Forward Earnings** *(link):* Forward earnings fell for all three of these indexes for the third time in the past four weeks, continuing the declines that began in mid-October during the Q3 earnings reporting season. The string of declines is the worst since the beginning of 2016 when oil prices were tumbling. LargeCap’s forward EPS dropped 20 cents w/w to $175.04 and is now 0.3% below its record high of $175.48 five weeks ago. Still, that’s better than the declines from the peaks for MidCap (-0.4%, last record high October 19) and SmallCap (-2.3, October 26). Forward earnings activity had been relatively strong in the past 12 months: LargeCap’s forward earnings have risen in 45 of the past 52 weeks, MidCap’s in 46, and SmallCap’s in 41. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016, but has clearly peaked. In the latest week, the rate of change in LargeCap’s forward earnings fell to a seven-month low of 20.9% y/y from 21.4%. 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 was down to a 10-month low of 22.1% from 22.7%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap’s dropped to a six-month low of 30.7% from 31.2% and is down from an eight-year high of 35.3% in early October, 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: LargeCap (23.3%, 8.3%, 10.5%), MidCap (21.4, 10.8, 11.8), and SmallCap (25.8, 14.3, 14.4).

**S&P 500/400/600 Valuation** *(link):* Forward P/E ratios fell broadly last week, but only LargeCap fell below late October’s lows. LargeCap’s weekly forward P/E fell w/w to 15.0 from 15.6, and is now the lowest since January 2016. That compares to a six-month high of 16.8 in mid-September, a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. However, last week’s level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap’s forward P/E dropped to 14.7 last week from 15.0, which is above late October’s 14.4 in the lowest reading since December 2012. MidCap’s P/E is down from a 15-year
high of 19.2 in February 2017 and the record high of 20.6 in January 2002. MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap’s P/E slipped to 15.6 last week from 16.0, which compares to 15.2 at the end of October in its lowest reading since December 2012. That’s well below its 51-week high of 20.2 in December 2017 (which wasn’t much below the 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed). Looking at the three indexes’ daily forward price/sales (P/S) ratios, most improved w/w but are also down to their lowest levels since early 2016: LargeCap’s P/S fell w/w to 1.87 from 1.94, which is down from a record high of 2.19 on January 26; MidCap’s decreased to 1.17 from 1.19, which compares to its record high of 1.40, also on January 26; and SmallCap’s dropped to 0.89 from 0.92, 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 Q3 earnings reports essentially complete, analysts are turning their focus toward cutting Q4 forecasts. Last week, the S&P 500’s blended Q4-2018 EPS forecast fell $0.15 w/w to $41.46. That’s down 2.6% since the end of Q3, up 6.6% ytd, and up 7.4% since the passage of the Tax Cuts and Jobs Act. The $41.46 estimate represents a forecasted pro forma earnings gain for Q4-2018 of 17.3%, down from 17.7% a week earlier and from 20.1% at the end of Q3. That would mark the slowest growth since Q4-2017 and comes on heels of 28.2% y/y growth in Q3, which is sure to mark the peak of the current earnings cycle. The blended Q4-2018 growth rate compares to Q3-2018’s 28.2%, Q2-2018’s 24.9%, Q1-2018’s 26.6%, Q4-2017’s 14.8%, Q3-2017’s 8.5%, Q2-2017’s 12.3%, and Q1-2017’s 15.3%. The S&P 500’s Q4-2018 forecasted earnings gain of 17.3% y/y would be its tenth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q4-2018, with seven at a double-digit percentage rate. That compares to all 11 positive during Q3, when 10 rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500’s blended y/y earnings gain of 17.3% during Q4, compared to four beating the S&P 500’s 28.2% gain during Q3. Analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago, with the pace slowing from Q3. The latest forecasted blended Q4-2018 earnings growth rates versus their Q3-2018 growth rates: Energy (83.3% in Q4-2018 versus 115.8% in Q3-2018), Financials (25.6, 44.7), Industrials (24.6, 18.8), Communication Services (17.9, 26.1), S&P 500 (17.3, 28.2), Consumer Discretionary (13.1, 25.2), Health Care (12.2, 16.7), Tech (12.0, 28.7), Real Estate (7.4, 5.3), Materials (6.1, 29.2), Consumer Staples (2.6, 11.3), and Utilities (-8.9, 10.9). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 14.6% y/y in Q4, below the 24.8% in Q3; that compares to 21.9% in Q2-2018, 24.5% in Q1-2018, 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). The Q4 estimate has fallen for 10/11 sectors since the end of Q3, and increased for one. Energy is the best performer, with its Q4-2018 forecast up 2.5% versus a 2.6% decline for the S&P 500. Materials is the biggest decliner, with its Q4-2018 forecast down 15.3% since the end of Q3, followed by Utilities (-7.2), Industrials (-4.9), Real Estate (-4.4), Communication Services (-4.0), Consumer Discretionary (-3.9), and Consumer Staples (-3.5).

S&P 500 Sectors Net Earnings Revisions (link): The S&P 500’s NERI turned negative in November for the first time in 19 months, ending its longest positive streak since the 26-month string ending August 2011. NERI fell to a 19-month low of -0.4% from 5.2% and is down from a record high of 22.1% in March. NERI improved m/m for just 1/11 sector and was positive for five sectors (compared to one improving and nine positive in October). Energy was the only sector with NERI improving m/m. Tech has the longest positive NERI streak, of 28 months, the best since August 2011 when its 28-month streak ended. Financials has the next best positive streak at 26 months, followed by Energy (13) and Industrials (12). Consumer Staples has the worst track record, with seven months of negative NERI, followed by Materials (2), which turned negative m/m in October for the first time in 13 months. Nearly all sectors are down from their TCJA-boosted highs in February and March. Here are the sectors’ November NERIs compared with their October readings: Utilities (4.6% in November, down from 5.9%
in October), Financials (3.7 [25-month low], 3.9), Tech (3.5 [20-month low], 8.3), Energy (2.1, 1.6), Consumer Discretionary (1.0 [11-month low], 3.8), Health Care (-0.1 [11-month low], 11.0), Industrials (-1.7 [22-month low], 12.3), Communication Services (-2.5, 21.7), Real Estate (-3.3, 0.1), Consumer Staples (-13.5, -10.6), and Materials (-15.7 [31-month low], -3.6).

US ECONOMIC INDICATORS

Regional M-PMIs (link): Four Fed districts have now reported on manufacturing activity for November—Philadelphia, New York, Kansas City, and Dallas—and they indicate factories continued to grow at a healthy, though slower rate. We average the composite, orders, and employment measures as data become available. The composite index fell to 17.2 after averaging 23.1 since last September. Composite indexes for the New York (to 23.3 from 21.1) and Kansas City (15.0 from 8.0) regions accelerated this month, while Dallas’ (17.6 from 29.4) and Philadelphia’s (12.9 from 22.2) decelerated. The new orders gauge (14.8 from 16.9) was slightly below last month’s pace. Orders growth in the Kansas City (20.0 from 7.0) region nearly tripled, while indexes for both Philly (9.1 from 19.3) and Dallas (9.7 from 18.9) were virtually halved. Meanwhile, New York’s (20.4 from 22.5) wasn’t far from October’s robust pace. The employment measure (13.1 from 15.1) reveals job gains also were just shy of October’s pace. Manufacturers in the both the Philly (16.3 from 19.5) and Dallas (15.9 from 23.9) regions hired at a slower pace than last month, though still faster than those in the New York (14.1 from 9.0) region, which actually showed a pickup in job growth this month; Kansas City (6.0 from 8.0) manufacturers hired at a much slower pace than those in the other three regions. Meanwhile, inflationary pressures have eased, according to the prices-paid and -received indexes for the four regions. Here’s a look at the prices-paid indexes for November versus their respective peaks this year: Philadelphia (to 39.3 from 62.9), Kansas City (41.0 from 55.0), New York (44.5 from 54.0), and Dallas (33.7 from 54.4). Here’s the same drill for the prices-received indexes: Philadelphia (21.9 from 36.4), New York (13.1 from 23.3), Dallas (7.5 from 17.5), and Kansas City (23 from 29)—with the latter holding near its high.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (link): “There are clear signs that the long upturn is ending, the Germany economy is cooling down,” according to Clemens Fuest, Ifo’s president. Sentiment among German firms weakened for the third month as the economy has cooled. Of the four sectors, business climate indexes for the manufacturing, services, and trade sectors all deteriorated again this month, while construction’s also eased after hitting a new record high in October. Within the trade sector, confidence improved for retailing but deteriorated for wholesaling. Overall business confidence fell for the third straight month, from a six-month high of 103.9 in August to a four-month low of 102.0 this month. November’s decline was the eighth this year. Both the present situation (to 105.4 from 106.7) and expectations (98.7 from 101.0) measures fell over the three-month period to their lowest readings in 14 months and four months, respectively. Ifo’s expectations component correlates closely with German factory orders and production, while the overall index tracks exports more closely. Recent Ifo data suggest a further slowdown. Meanwhile, Germany’s IHS Markit Flash M-PMI sank to a 32-month of 51.6 in November.

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