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Economics Group

Special Commentary

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Should We Worry About American Debt?: Part III

Financial Health of Business Sector is OK, At Least for Now

Executive Summary

In the third part of our series on debt in the U.S. economy, we focus on the debt of the business sector. Business debt has risen by roughly $5 trillion over the past decade, and the debt-to-GDP ratio in the sector currently stands at its highest in at least 40 years. But balance sheets generally remain sound, and strong cash flow gives most businesses the wherewithal to service their debts without much difficulty, at least at this time.

That said, the financial health of the business sector is not as strong as it was a few years ago. The increase in debt in the business sector in recent years probably will not be the catalyst for recession, at least not in the near term. But the increase in corporate debt over the past decade means that some businesses may not be able to weather a downturn, should one occur, as well as they would have a few years ago.

Business debt has risen by roughly $5 trillion in the past decade.

Business Sector Debt Has Risen Significantly in Recent Years

In Part I of this series we showed that the total amount of debt in the overall U.S. economy has risen by more than $15 trillion (nearly 30%) over the past ten years. But the debt of the household sector, which we addressed in Part II, is up by less than $2 trillion over that period. Indeed, we argued in that report that the financial health of the consumer sector has generally improved over the past decade, and that the risk of an economic downturn stemming from excessive household debt seems to be rather low at this time. In this, our third report in the series, we focus on debt in the non-financial business sector.

Figure 1

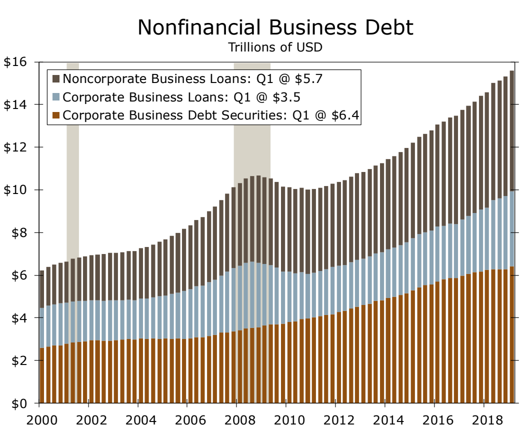
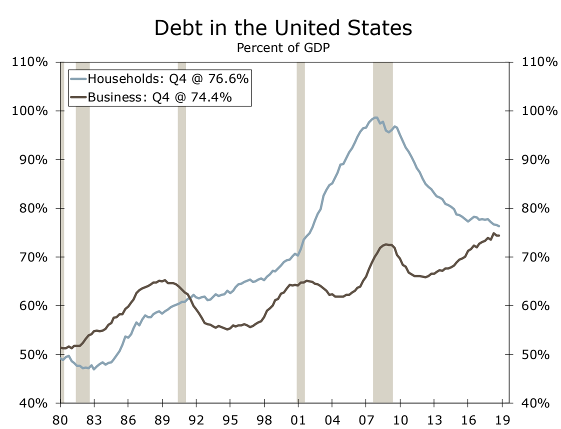


Figure 2



Source: Federal Reserve Board, Bank of International Settlements and Wells Fargo Securities

Together we'll go far

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Debt in the non-financial business sector has risen from nearly $11 trillion about ten years ago to roughly $16 trillion today (Figure 1). Non-financial corporations, which tend to be the largest business organizations in the economy, account for the majority of this debt (about $10 trillion). Drilling down further shows that there are $6.4 trillion worth of corporate bonds outstanding and $3.5 trillion worth of bank loans that have been extended to the corporate sector. Loans to non-financial non-corporate businesses currently total $5.7 trillion.

As discussed in our previous report and as shown in Figure 2, the debt-to-GDP ratio of the household sector has receded markedly over the past decade. In contrast, the comparable ratio for the non-financial business sector has trended higher in recent years and is now about 9 percentage points higher than it was relative to its recent nadir in 2012. Moreover, the debt-to-GDP ratio of the business sector presently is the highest it has been in at least 40 years. Is the business sector over-indebted?

How Financially Healthy is the Business Sector?

In this section, we update the analysis we did last year on the financial health of the non-financial corporate (NFC) sector and the non-financial non-corporate (NFNC) sector. As shown above, the debt-to-GDP ratio of the overall business sector currently stands at 74% with the NFC sector accounting for 47 percentage points of this overall ratio and the NFNC sector representing a 27 percentage point share (Figure 3). Because it comprises the lion's share of business sector debt, we will focus on the NFC sector in the remainder of this report.

Figure 3

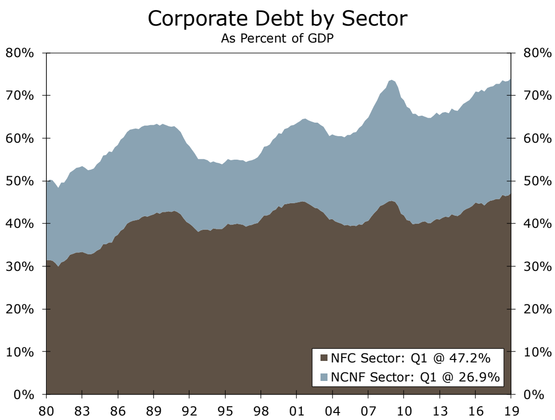
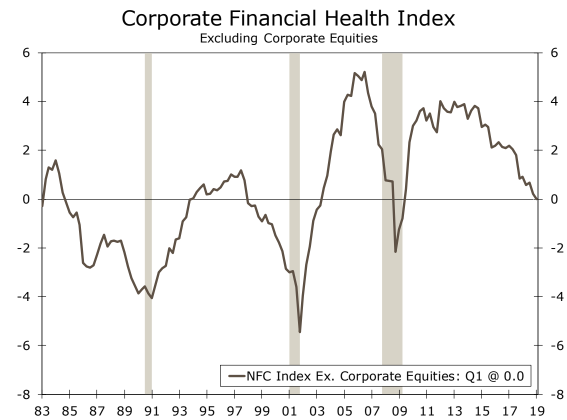


Figure 4



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities

The NFC sector probably has adequate cash flow to service its debts, at least at present.

As discussed in more detail in our report last year, we have constructed an index, which is based on eight metrics that the academic literature has identified as important determinants of the financial health of the corporate sector. The downward movement in our index over the past few years indicates that the financial health of the NFC sector has deteriorated over that period (Figure 4).[1] Part of this deterioration reflects the 225 bps of monetary tightening that the Federal Reserve has undertaken since late 2015 that has lifted corporate borrowing costs. As shown in Figure 5, the interest coverage ratio, which measures the amount of cash flow that the NFC sector has to service its debt, has receded over the past few years. That said, the ratio, which is not abnormally low in a historical context, suggests that the NFC sector probably has adequate cash flow to service its debts, at least at the present time.

[1] We plot our "adjusted" Corporate Financial Health Index, which excludes the value of corporate equities in Figure 4. The stock market was in a bubble in the late 1990s, which collapsed in 2000. Including the value of equities that companies held on the asset side of their balance sheets gives an overly sanguine assessment of corporate health during the late 1990s, in our view. See our previously referenced report for more details.

Figure 5

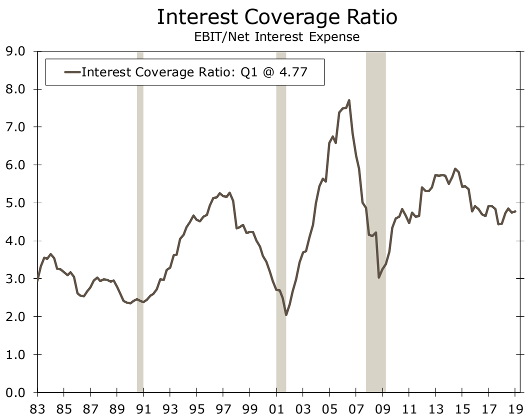
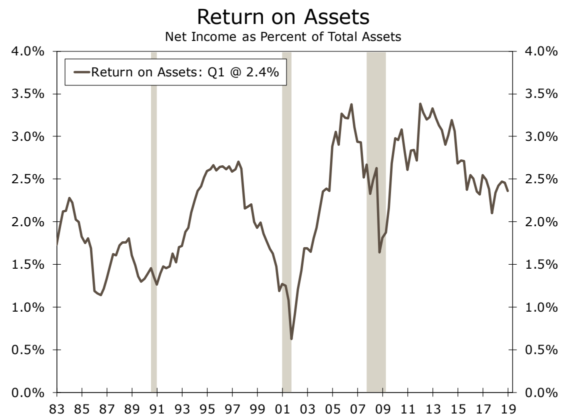


Figure 6



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

The index has also been pulled down by the trend decline in the return on assets in recent years (Figure 6). Although after-tax profits jumped when corporate tax rates were cut at the start of 2018, net income still remains below the levels reached in H2-2014.[2] In the meantime, corporate assets have risen, implying that the return on those assets has declined. That said, the return on assets in the NFC sector generally remains at a fairly high level.

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The rise in debt that was noted previously has also started to push down the debt-to-assets ratio in the NFC sector over the past few quarters (Figure 7). But this ratio also remains at a high level in a historical context. The market-to-book ratio (i.e., the market value of firms relative to their book value) edged down in Q4-2018 as the stock market tumbled at the end of last year, but the ratio recovered some lost ground in the first quarter (Figure 8). With the stock market rising to all-time highs again, it appears that investors generally remain fairly optimistic about the future stream of corporate earnings.

Figure 7

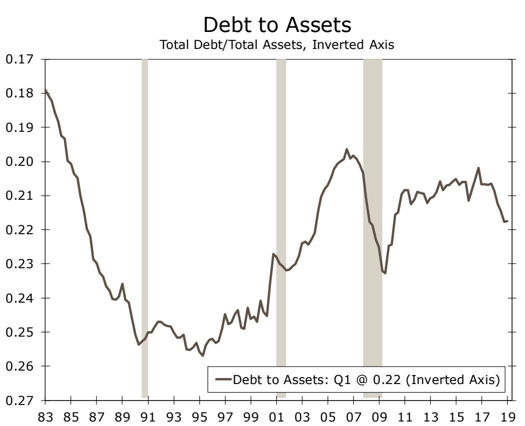
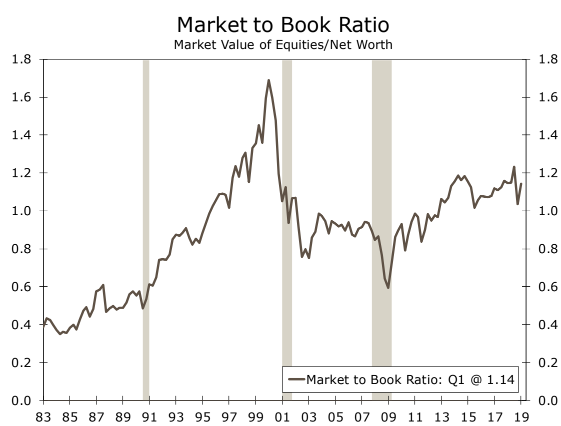


Figure 8



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

So where does this leave us? Debt on business balance sheets has risen by roughly $5 trillion over the past decade, but there are few signs of financial stress at present. Credit spreads generally remain tight, and the stock market has risen to an all-time high. This general lack of financial stress

[2] The collapse in oil prices that started in the second half of 2014 weighed on profits in the energy sector. Additionally, the downturn in investment spending in the energy sector hurt profitability among producers of capital goods.

The underlying fundamentals of the business sector are fairly sound at present.

is probably warranted because, in our view, the underlying fundamentals of the business sector are fairly sound at present. Assets have more or less kept pace with the rise in debt, so corporate balance sheets remain generally solid. The rise in interest rates over the past few years has pushed up borrowing costs, but strong cash flow generally gives businesses the wherewithal to service their debts without much difficulty at this time.

The operative phrase in the previous sentence is “at this time.” The modest decline in the interest coverage ratio over the past few years shows that rising interest rates would make it more difficult for businesses to service their increased debt load, everything else equal. The good news is that the Federal Reserve probably will not be raising rates anytime soon. Indeed, the Fed is more likely to cut rates than to hike them, at least in the near term. So businesses probably do not need to fret about higher borrowing in the foreseeable future.

But a recession, should one occur for any reason, would slow revenue growth and make it more challenging for the business sector to service its debt. Excessive debt in the business sector probably will not be the catalyst for recession, at least not at this time. But unforeseen shocks can sometimes trigger a recession, and some businesses today may have more difficulty surviving a downturn than they would have had a few years ago when they were less levered.

Conclusion

In Part II of this series, we concluded that the financial health of the household sector has generally improved over the past decade. The picture in the business sector is more mixed. Business debt in the United States has risen by roughly $5 trillion over the past decade, and the debt-to-GDP ratio in the sector currently stands at its highest ratio in at least 40 years. But balance sheets are generally in solid shape and most businesses are able to service their debts without much difficulty. In short, the financial health of the business sector is not as strong as it was a few years ago, but it is not so weak at present to make us unduly alarmed either. We would be more concerned about the business sector if the Fed were aggressively hiking rates. But further monetary tightening does not appear to be on the radar screen anytime soon.

Excessive debt in the household sector a decade ago triggered the last recession. The increase in debt in the business sector in recent years probably will not be the catalyst for recession, at least not in the near term. But the increase in corporate debt over the past decade means that some businesses may not be able to weather a downturn, should one occur, as well as they would have a few years ago.

In upcoming installments of this series, we will analyze debt in the federal government, the state and local government and the financial sectors. We will then conclude with a grand assessment of debt in the U.S. economy.

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