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Economics Group

Special Commentary

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Is Corporate Debt About to Rear Its Ugly Head?

Executive Summary

As we have written in previous reports, a number of financial metrics suggest that the financial health of the non-financial corporate (NFC) sector has deteriorated over the past few years. Although we may not necessarily be on the cusp of a corporate debt-induced downturn in the U.S. economy, the NFC sector is more financially fragile today than it was a few years ago. If a recession were to occur, non-financial corporate businesses could cut payrolls in an effort to improve profitability. The debt in the NFC sector may not be the catalyst of the next downturn, at least not in the foreseeable future, but any recession that occurs in the near term could be exacerbated by the build-up of non-financial corporate debt over the past decade.

Financial Health of the NFC Sector Continues to Deteriorate

In a series of reports over the past year, we have discussed our concerns about the rising amount of debt among non-financial corporations.[1] We were particularly concerned last autumn when the Federal Reserve was in the midst of a tightening cycle. In our view, rising leverage in the NFC sector in conjunction with monetary tightening could have potentially been a catalyst for the next economic downturn. A year later, the Fed has eased policy rather than continue to tighten, and the immediacy of increasing leverage among non-financial corporations has faded from the minds of many investors. But the financial health of the NFC sector continues to deteriorate. As shown in Figure 1, our corporate financial health index (CFHI) has moved lower since we first developed it over a year ago.

As we discussed in our September 2018 report, the CFHI is a succinct distillation of eight metrics that are important determinants of corporate financial health. But perhaps a more straightforward way to think about the financial health of the NFC sector is to simply consider the ratio of corporate debt to some measure of cash flow that is available to service that debt. Many readers will be familiar with the debt-to-EBITDA ratio and its implications for debt-servicing capacity.[2] Because we do not have readily available measures of depreciation and amortization on an economy-wide basis, we plot the NFC sector's debt-to-EBIT ratio, which we consider to be a reasonable proxy for the broader debt-to-EBITDA ratio (Figure 2).

The debt-to-EBIT ratio for the NFC sector has trended higher over the past few years.

As Figure 2 makes apparent, the debt-to-EBIT ratio for the NFC sector has trended higher over the past few years and currently stands at a level that has only been surpassed in the early years of the 21st century and briefly in 2008-2009. However, one should find little consolation in the higher ratios that were reached during those periods. The spike in the debt-to-EBIT ratio that occurred in 2000-2001 and again in 2008-2009 happened during recessions. The swoon in earnings that transpired during those economic downturns pushed the overall ratio higher.

[1] See "U.S. Corporate Sector Health: Should We Worry?" (September 27, 2018), "Which Sectors Have Driven Business Sector Debt Growth" (October 29, 2018) and "Should We Worry About American Debt?: Part III" (June 25, 2019).
[2] EBITDA is an acronym for Earnings Before Interest, Taxes, Depreciation and Amortization.

Figure 1

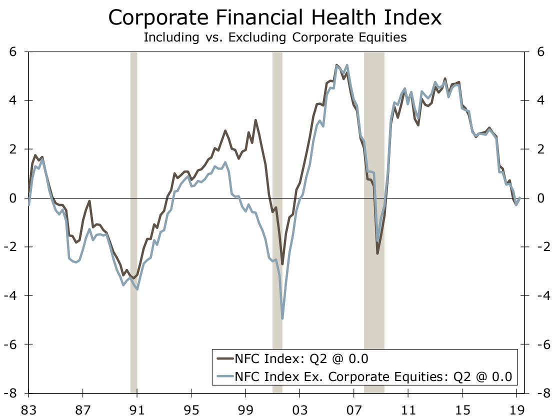
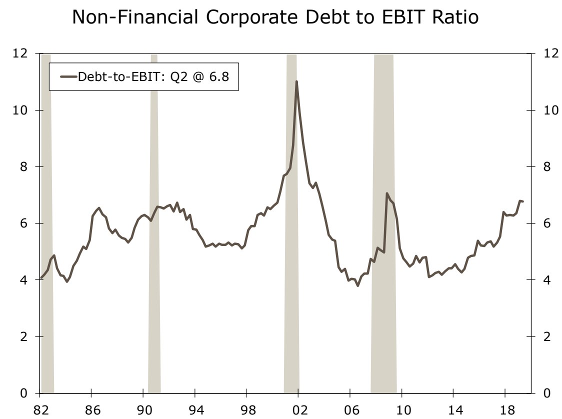


Figure 2



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

That said, an elevated debt-to-EBIT ratio is not necessarily a harbinger of impending financial doom for the NFC sector or the broader macro-economy. For example, there was little financial strain in the NFC sector in the mid-1980s even though the debt-to-EBIT ratio was elevated at that time. So we are not suggesting that a debt-induced downturn in the U.S. economy is necessarily imminent today. But corporate earnings could weaken rapidly if some unforeseen exogenous shock were to tip the U.S. economy into recession. If the resulting weakness in revenues causes businesses to experience debt-servicing difficulties, then the downturn could deepen as they attempt to cut costs via headcount reductions and retrenchment in investment spending. Therefore, a deeper dive into the financial health of the NFC sector at present is warranted.

Debt-Induced Downturn is Not Necessarily Imminent

The interest coverage ratio in the NFC sector has moved lower over the past few years.

In our view, the interest coverage ratio is one of the most important metrics of corporate financial health. This ratio essentially measures how much cash flow non-financial corporations have to service their debts. As shown in Figure 3, the interest coverage ratio in the NFC sector has moved lower over the past few years. In other words, the ability of many non-financial corporations to service their debts has weakened somewhat in recent years. That said, the ratio does not appear to be inordinately low at present.

Figure 3

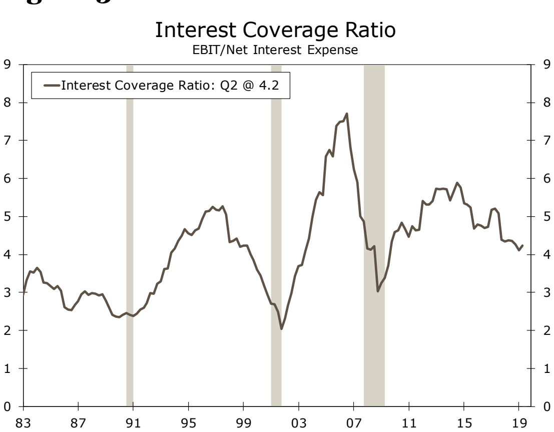


Figure 4

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

The interest coverage ratio is essentially a function of three other variables. First, there is a direct relationship between the interest coverage ratio and the amount of corporate debt. That is, the ratio rises in line with the amount of NFC debt, everything else equal. The amount of outstanding debt among non-financial corporations has swelled by $3.6 trillion since the current expansion began ten years ago. Consequently, the debt-to-GDP ratio of the NFC sector has climbed to nearly 47%, the highest ratio since data begin at the end of the Second World War (Figure 4).

But even though non-financial corporations were adding to their debt as the economy began to recover from the Great Recession, debt-servicing costs were held in check by the second variable that influences the interest coverage ratio. Namely, interest rates fell markedly. For example, 1-month LIBOR, which is an important benchmark borrowing rate for many businesses, plunged roughly 500 bps between mid-2007 and mid-2009. Rates further out the curve also fell sharply. An index of 10-year yields on Baa-rated corporate bonds dropped from more than 10% in October 2008 to roughly 3% in April 2013.

Higher rates have weighed on the interest coverage ratio.

As noted above, however, the interest coverage ratio in the NFC sector has trended lower since late 2014 due to two developments. First, interest rates have risen over that period. Between December 2015 and December 2018 the Federal Open Market Committee (FOMC) raised its target range for the fed funds rate 225 bps, and longer-term borrowing costs also trended higher over that period. Although the FOMC has subsequently cut rates 75 bps, short-term interest rates are higher today than they were a few years ago. Second, earnings growth, which is the third variable that influences the interest coverage ratio, has generally slowed. As shown in Figure 5, EBIT growth has trended lower since 2012. With economic growth in the United States likely to remain lackluster for the foreseeable future, a marked acceleration in earnings does not seem very likely.[3] Therefore, the interest coverage ratio of the NFC sector probably will not rise meaningfully anytime soon.

Figure 5

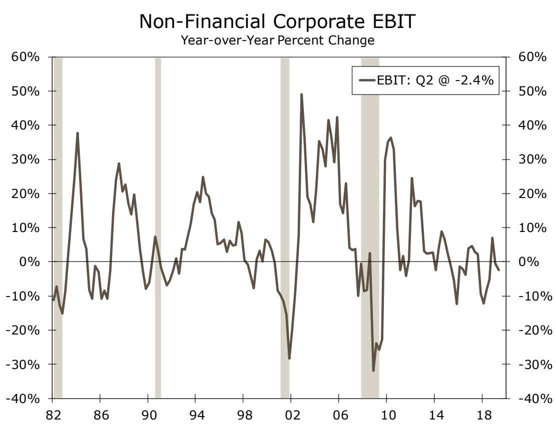
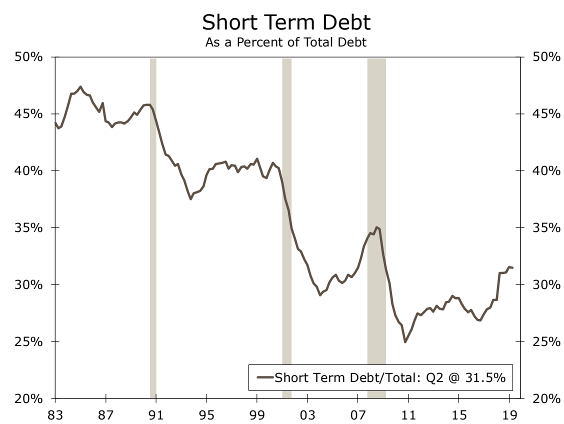


Figure 6



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

The interest coverage ratio could nosedive if interest rates were to shoot higher. But as we have written in our latest *Monthly Economic Outlook*, the FOMC likely will refrain from hiking rates again for the foreseeable future. Furthermore, non-financial corporations have used the period of extraordinarily low long-term interest rates to extend their debt profiles. As shown in Figure 6, the percentage of total NFC debt that is accounted for by short-term debt, which has been trending lower since the early 1990s, fell to only 25% in the immediate aftermath of the Great Recession. Although the percentage has edged up over the past few years, it remains low in a historical context.

Furthermore, some observers argue that ample quantities of cash on corporate balance sheets strengthens the financial resiliency of the NFC sector. True, the liquid assets of the NFC sector have

[3] We project that nominal GDP in the United States will grow 4.0% in 2019, and our forecast looks for growth to remain near this rate in 2020 and 2021. We do not forecast EBIT explicitly but we look for economy-wide pre-tax corporate profits to grow only 2.3% next year 2.5% in 2021. See our *Monthly Economic Outlook* for details. For a brief discussion of how our measure of economy-wide corporate profits differs from S&P 500 corporate profits see "Corporate Profits: A Problem in 2019?" (December 17, 2018).

The net debt position of the NFC sector is not as healthy as it was a few years ago.

soared to a record $4.5 trillion today (Figure 7). But the financial resiliency of the NFC sector is not quite as solid as these cash holdings may suggests. Net debt, which is defined as the total outstanding debt of the NFC sector less its liquid assets, also stands near a record of $5.5 trillion today. The ratio of net debt-to-GDP of the NFC sector has trended higher over the past few year and currently stands above 25%. Although not as high as the ratios in excess of 30% that were reached in the late 1980s and early 1990s and again during the Great Recession (the sharp draw down in liquid assets during that period temporarily pushed up the ratio), the net debt-to-GDP ratio is elevated today in a historical context.

When measured against cash flow, the net debt position of the NFC sector is not as healthy as it was a few years ago. As shown in Figure 8, the net debt-to-EBIT ratio has risen noticeably since 2014. (The ratio spiked higher in 2001 and again in 2008-2009 as EBIT fell sharply during those recessions.) So even when the liquid assets of non-financial corporations are taken into account, the financial health of the NFC sector has nevertheless deteriorated over the past few years.

Figure 7

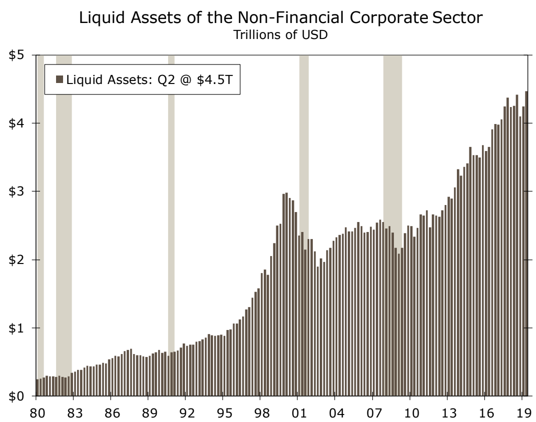
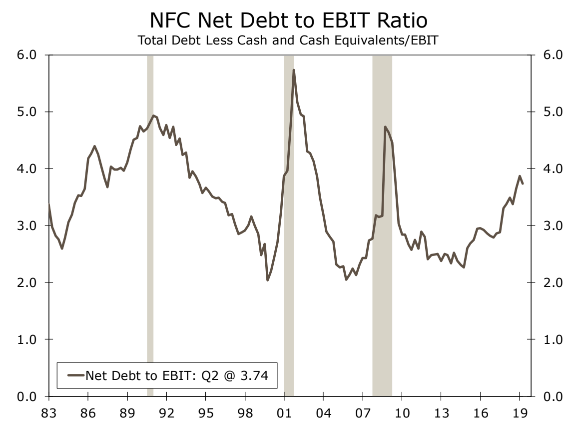


Figure 8



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

Conclusion

Although the financial health of the NFC sector has deteriorated, we do not believe that we are necessarily on the cusp of a corporate debt-induced downturn in the U.S. economy. Spreads of investment grade bonds over U.S. Treasury securities generally remain tight as do comparable spreads on high yield corporate bonds. Thus, the collective judgement of market participants indicates that a bout of significant financial stress among non-financial corporations does not seem to be likely, at least not at this time. Moreover, the financial metrics that we analyzed in this report are generally not at levels yet that would lead us to believe that a bout of financial stress is imminent. As we noted at the beginning of this report, we were more concerned about the financial health of the NFC sector about a year ago when the Fed was tightening policy. The easing that the FOMC has undertaken since July should help to lessen any financial strains that the NFC sector may be feeling.

That said, the financial health of the NFC sector is more fragile today than it was a few years ago. Although Fed tightening will not be the catalyst that triggers financial stress among non-financial corporations, at least not for the foreseeable future, the NFC sector could be vulnerable to an unforeseen exogenous shock that causes a recession. Some unforeseen exogenous event and/or profit swoon could potentially cause a recession. In an effort to restore their slumping profitability, these businesses could pare payrolls, which would weigh on consumer spending and thereby deepen the recession. Although the NFC sector debt may not be the catalyst of the next downturn, at least not in the foreseeable future, any recession that occurs in the near term could be exacerbated by the build-up of non-financial corporate debt over the past decade.

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