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Americas CIO View

Corporate debt is rising, but against more assets and low interest rates

In a nutshell

- Debt-to-GDP ratio is a misleading metric: debt is a four letter word, but not a curse
- Corporate debt has been rising, but serviceability is still near record highs
- Corporate leverage is higher at small caps and presents risk at Energy
- Trade tension is escalating, Fed unlikely to cut unless U.S. jobs wobble

Debt-to-GDP ratio is a misleading metric: debt is a four letter word, but not a curse

Corporate debt to gross domestic product (GDP) is being cited by some as an indication that Corporate America has taken on too much debt. U.S. non-financial corporate liabilities are now 98% of U.S. GDP, a bit below 2017's record high of 102%, but otherwise the highest since 1960. However, GDP denominator-based leverage metrics can be very misleading for corporates and households. It is typical for debt relative to GDP to rise over time in these two sectors because assets relative to GDP tend to rise over time in companies and households. Prosperous and growing economies tend to add more income producing assets relative to GDP (capital deepening), like factories, equipment, commercial structures and housing. Debt is also in part funding intangible assets like R&D at companies and education in households. We prefer to look at debt relative to assets and be mindful of the value of the assets as influenced by interest rates and supply-and-demand factors that influence the returns earned by such real-economy assets. Even though U.S. non-financial corporate liabilities to GDP is at an all-time high, the liabilities-to-assets ratio has been stable and is in line with the past two cycles, and the net worth of non-financial corporate businesses is at an all-time high.

Corporate debt has been rising, but serviceability is still near record highs

The U.S. 10-year Treasury yield averaged 2.3% since 2011, this compares to a 6% average since 1960. Corporate America took advantage of the very low long-term nominal and real interest rates this cycle by using more long-term debt in their debt mix. Long-term debt is at an historic high of total debt at 87%.

Non-financial S&P 500 companies' cash holding reached an all-time high of 1.9 trillion U.S. dollar (USD) at 2017 end, but since then, share buybacks ramped up owing to more tax-efficient accessibility of offshore cash. Cash is down 275 billion USD since 2017 end, reflecting the 300 billion USD more the S&P 500 spent on net buybacks in 2018 vs. previous several years.

Owing mostly to less excess cash, net debt to EBITDA of S&P 500 non-financial companies climbed to 1.89 (on a trailing four-quarter basis as of the first quarter of 2019) from 1.63 at 2017 end. This compares to an average of 1.57 since 1967 outside of recessions plus two years after. However, in order to take into account the benefit of a much lower corporate tax rate, we also looked at net debt to NOPAT (net operating profit after tax). Based on this metric, net debt to NOPAT is 3.12, which is below the average of 3.31 since 1967 outside of recessions. S&P 500 non-financial net debt to market cap has been trending down since 1990, except for spikes

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during recessions. It climbed in 2015-16, mostly in Energy, but remains low vs. history at 18% vs. a roughly 25% long-term average. We acknowledge that some S&P 500 corporate leverage measures have risen in recent years, but they are not elevated vs. longer-term norms and this is before accounting for the benefits of lower interest rates by evaluating interest cost serviceability.

Interest coverage ratios, such as EBITDA/net interest expense, remain very strong and given the high usage of long-term funding will stay strong provided earnings do not sharply decline. S&P 500 non-financials EBITDA is 10.6x gross interest expense and 12.4x net interest expense. And there is 2.2x as much cash as short-term debt.

Corporate leverage is higher at small caps and presents risk at Energy

For Russell 2000 ex Financials, net debt to EBITDA is 2.78 and net debt to NOPAT is 5.18, both at or close to their historic highs out of recessions. Among all sectors of the S&P 500, Energy saw its leverage ratio shoot up and interest coverage deteriorate quickly during the 2015-2016 oil price collapse, thus it is the most vulnerable in our opinion. Real Estate and Utilities have the highest leverage and lowest interest coverage ratios, followed by Consumer Discretionary, Consumer Staples, Industrials and Materials.

Trade tension is escalating, Fed unlikely to cut unless U.S. jobs wobble

President Trump's intention to tariff Mexico imports to stem the tide of illegal migration is further unnerving investors. If trade policy will now be a frequently used foreign policy tool anywhere at any time, investors will have to totally reevaluate the risks posed to individual companies and industries. If these tariffs are implemented, it raises high risk of a near-term S&P 500 correction. Some investors think the Fed will cut upon a correction, we think this is unlikely unless the S&P 500 falls into a deep correction or the jobs reports start indicating damage to the U.S. jobs market from tariffs. We reiterate our tactical caution for summer and advise over-weighting secular growth stocks and bond substitute stocks with low trade or cyclical sensitivity.

Appendix: Performance over the past 5 years (12-month periods)

	05/14 - 05/15	05/15 - 05/16	05/16 - 05/17	05/17 - 05/18	05/18 - 05/19
U.S. 2-year Treasuries	0.8%	0.7%	0.6%	-0.1%	3.5%

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Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 6/3/19

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Glossary

Correction

A **correction** is a decline in stock market prices.

EBITDA

EBITDA (earnings, before interest expenses, taxes, depreciation and amortization) is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Interest coverage

Interest coverage is calculated by dividing a company's earnings by its interest payments over a given period.

Leverage

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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