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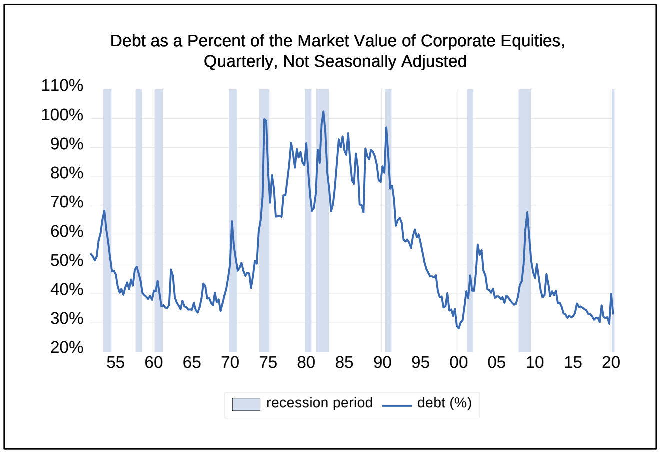
So, After All that Bond issuance and Equity Markets Rally Where are We?

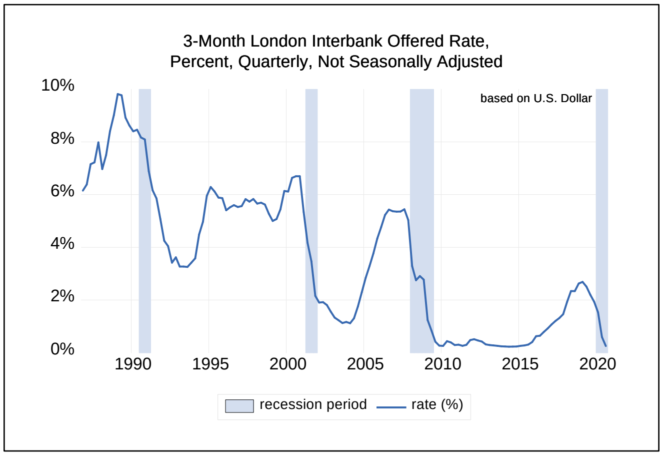
"But in retrospect, the growth of debt and leverage was out of line with subsequent economic expansion and asset appreciation." Chairman Greenspan, Monetary Policy Report to Congress February 1992.

Verification of the value of bond issuance and equity valuations today depends on growth tomorrow. Debt today must be paid out of earnings tomorrow. Last week we reviewed today's Treasury issuance considering the downshift in CBO growth estimates for the future. Now, at first glance the ratio of bonds to equity values, graph lower left, is reassuring as debt has certainly declined relative to equity. But, upon closer examination, the problem is obvious.

It is not the fall that kills you, it is the sudden stop. In this case, the problem is that recessions are the sudden stop and the drop in corporate profits eviscerates equity valuations. Moreover, reduced profits mean a reduced margin of safety for debt payments. Net, the secular decline in debt to equity ratios is also characterized by cyclical spikes associated with recessions.

This debt/equity pattern becomes more intriguing when we note the intracycle pattern of short-term interest rates that is independent of the economic cycle (graph lower right). Short-term business financing rates evidence a mid-cycle rise in the 1980s, 1990s, 2000s and 2010 expansions. There is a secular pattern of lower LIBOR rates over time. However, there is also a cyclical pattern of low rates after a recession and then a rise in rates as the economic expansion ages. For business leaders, the interaction of these financial patterns presents both opportunity and challenge to financing decisions.

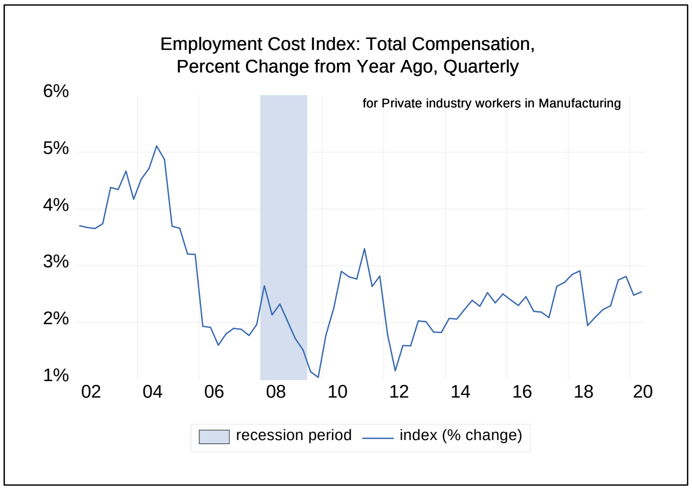




“Investors Brace for Hit to Profits as Costs Rise” April 3, 2019 Wall Street Journal

This past week the employment cost index release for the third quarter of 2020 indicated a rise in employment costs of 2.4 percent in the third quarter compared to a rise of 2.8 percent a year ago. Wages and salaries rose 2.5 precent compared to a year ago rate of 2.9 percent. The profit cycle, and thereby the cycle for debt interest coverage and equity valuations is a product of aggregate economic growth but also the pattern of underlying business costs.

The employment cost index, graph below, has a distinct cyclical pattern. The lows appear soon after a recession and therefore are associated with a pickup in corporate profit growth consistent with a pickup in real final sales as productivity rises quickly and labor compensation lends to lag the economic cycle. Productivity spikes in the nonfarm business sector appear in 1992, 2003 and 2009—all in the early phases of an economic recovery.



During the 2010 recovery and expansion, the growth of the employment cost index was very gradual and never reached the peak of 3 percent achieved in the 1Q of 2007. Therefore, the basis for a longer period of profit growth and equity market appreciation was in place.

Now, the issue is that is this latest evidence on the employment cost index evidence of a structural change towards a more moderate pace of labor costs? If so, then bond and equity valuations may be better supported with corporate earnings. But if not, perhaps current earnings will not be sustained.

What do the Markets Indicate?

Corporate AA spreads were at 0.80 percent in October which is the same as the Jan. 2019 spread. From February 2019 to January 2020, the spread was below that level. Today’s spreads are more “normal” by prior economic expansion comparison.

The ICE BofA high yield index spread was at 5.03% in October which is above the pre-shutdown recession period average during the 2017-2019 period. Market pricing has moved to a more reasonable pricing regime. As the current economic expansion continues will spreads narrow in line with prior expansion? We shall see.

Spreads on corporate debt reflect the cyclical and secular character of short-term to long-term debt ratios. During the periods of 2004 2006 and again in 2010 to 2012, short-term debt rose but over the entire 2002 to 2017 period, the ratio of short-term to long term debt declined. On net, nonfinancial corporations have reduced their sensitivity to changes in short-term interest rates and perhaps the vagaries of the pace of economic growth over the short-term.

Along with the ratio of short-term to long-term debt, we cited However, there could be a catch—if firms are committed to a series of long-term interest payments that would be excessive if the pace of economic growth were to significantly slow over time (note CBO reference above) then the burden of that long-term interest commitment relative to a slower pace of earnings to pay that debt would create financial stress.