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MARKET REVIEW
NOVEMBER 2019

SMB Trust Services

DO NOT SOUND THE ALARM ON CORPORATE LEVERAGE

In recent years, the debt of U.S. companies has increased to a record level. A commonly cited measure of an economy's business leverage, non-financial corporate debt as a percent of GDP, reached 46.6% in the second quarter, its highest level since 1936. Over the last nine years, debt outstanding among non-financial corporations has grown at an average rate of 5.7% per year, adding $3.8 trillion to their overall debt. The financials sector is typically excluded from this analysis to avoid skewing the data since their business models utilize higher amounts of debt and leverage. In addition to the usual factors that drive borrowing, such as capital needed to expand business operations, the unprecedented stimulus programs of the Federal Reserve in response to the 2008 financial crisis provided another catalyst for debt growth. The Fed's reduction of short-term interest rates to a historical low created an environment conducive to higher borrowing.

Some economists and investors have expressed concern about the level of corporate leverage and companies' capacity to meet their debt payments if a sharp tightening in financial conditions or economic downturn materializes. For instance, the Federal Reserve and International Monetary Fund (IMF) have cited the amount of corporate debt as a top risk in their financial stability reports. Although, comments from the Fed and IMF suggest they only view corporate debt as a moderate risk as opposed to a systemic risk akin to subprime-mortgage borrowing before the 2008 financial crisis. Earlier this year Federal Reserve Chairman Powell said, "The current situation looks typical of business cycles." The IMF's financial stability report noted, "Debt-service capacity has improved in most advanced economies, and balance sheets appear strong enough to sustain a moderate economic slowdown." The remainder of this market brief will review aspects of the corporate leverage situation in order to demonstrate why elevated corporate debt does not pose a near-term threat to the U.S. economy.

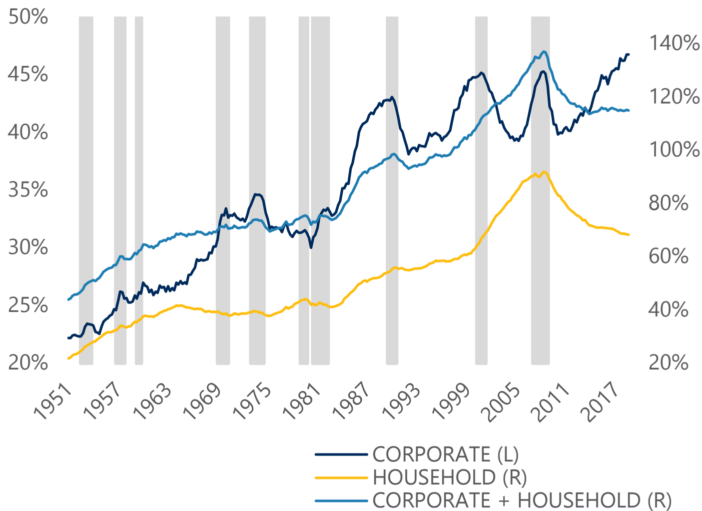
OTHER DEBT METRICS TELL A DIFFERENT STORY

Focusing on the absolute amount of debt outstanding does not capture the full picture of corporate leverage. It is useful to examine other debt metrics such as interest coverage and net debt to operating profits in order to assess whether companies are taking on more debt than they can afford. Interest coverage measures how easily companies can cover their debt payments with operating profits. Interest coverage for non-financial S&P 500 companies surged after the 2008 recession to a record high near 13.0 and has remained close to that level. Despite companies taking on more debt, interest coverage has not deteriorated as a result of growing profits and record low interest rates. Low interest rates since the financial crisis have kept interest expense down which makes it easier for companies to carry more debt at a low cost.

Net debt to operating profits is another measure of companies' capacity to pay debt. This metric compares total debt minus cash to operating profits. Cash is subtracted because in theory it could be used to meet near-term debt obligations, if needed. S&P 500 non-financial companies' net debt to operating profits has risen modestly in recent years to 1.8. This level is only a little worse than the historical average of 1.6 since 1967, outside of recessions. Another version of this metric, net debt to net operating profits after taxes, takes

U.S. DEBT AS A PERCENT OF GDP

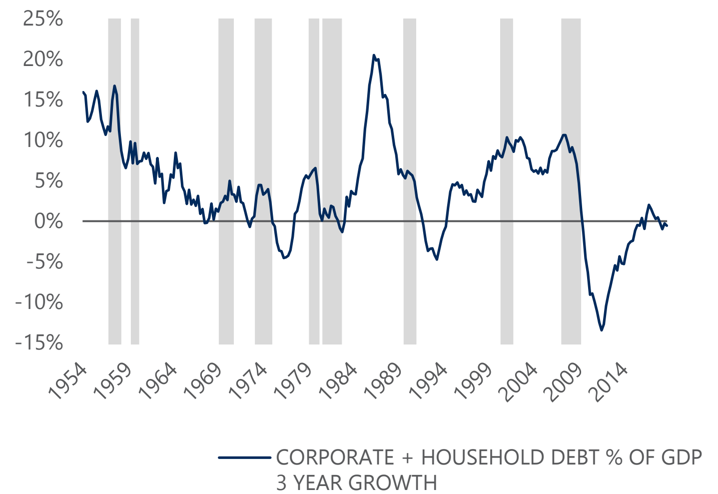
NON-FINANCIAL CORPORATE AND HOUSEHOLD DEBT



Shaded bars indicate recessions. Source: Federal Reserve Board of St. Louis
Past performance does not guarantee future results.

U.S. PRIVATE DEBT GROWTH

CORPORATE & HOUSEHOLD DEBT/GDP THREE YEAR GROWTH



Shaded bars indicate recessions. Source: Federal Reserve Board of St. Louis
Past performance does not guarantee future results.

into account the benefit of lower taxes rates. This version of the metric is 3.12, which is better than the long-term average of 3.3. Healthy levels of interest coverage and net debt to operating profits indicate S&P 500 non-financial companies should be able to sufficiently cover their debt payments and have some financial flexibility to navigate a decline in economic conditions.

DEBT GROWTH IS MORE IMPORTANT THAN AMOUNT OF DEBT

The conventional theory about corporate leverage posing a risk to the economy is based on the view that excessive borrowing makes companies more vulnerable to economic shocks and could lead to a more severe economic downturn if distress in companies' financial health forces them to cut back on spending or lay off employees. Recent evidence contradicts this view. A 2017 paper from the Bank of England (BoE) reviewed 130 recessions across 26 countries and concluded that the rate of private debt (corporate and household) growth is more important than the amount of debt. Debt growth in their research was defined as the three-year change in the debt-to-GDP ratio. The researchers found a strong economic link between the severity of recessions and private debt growth immediately preceding economic downturns. They did not find a similar relationship between recessions and the level of debt as a percent of GDP. In addition, they found rapid debt growth is associated with worse recessions even when the level of debt is not elevated. These findings suggest that high amounts of debt do not make recessions more severe, but instead debt growth is the mechanism that impacts recessions.

Every recession since World War II was preceded by elevated private debt growth above 8.0% or excessive inflation. The chart above (right) shows that the current private debt three-year growth rate is benign at negative 0.56%. Inflation is also tame with September's headline CPI at 1.7%. Neither of these factors is at levels seen historically before recessions. One criticism of this analysis is that combining corporate and household debt into one metric may lead to one sector masking the other. For instance, corporate debt growth of 4.2% is being masked by strong household deleveraging. This criticism is partially mitigated by the fact that the BoE's analysis showed that debt growth for households and corporations has similar statistical coefficients with recession severity. This means the economic risk of elevated corporate debt growth could be buffered by household's negative debt growth.

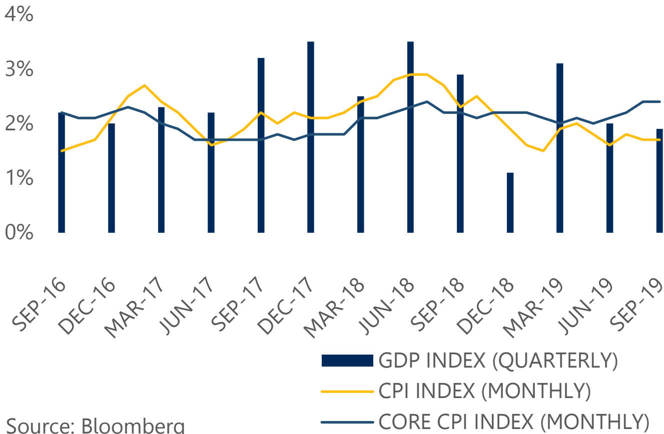
CONCLUSIONS AND INVESTMENT IMPLICATIONS

Concerns about the amount of corporate debt have intensified as debt as a percent of GDP reached its highest level in over 80 years. Corporate leverage at its current level likely does not pose a major near-term risk to the economy for a few reasons. First, corporations' financial health is still in good condition including their ability to pay their debt obligations. Second, research shows that the growth of debt is more important than the amount of debt. The current growth in debt is not excessive. Lastly, households' significant deleveraging since the 2008 financial crisis may partially offset the economic risk from elevated corporate debt. For the time being, it may be more appropriate to view corporate leverage as an idiosyncratic risk rather than a systemic risk.

ECONOMY

GDP AND CONSUMER PRICES

SEPTEMBER 2016 THROUGH SEPTEMBER 2019

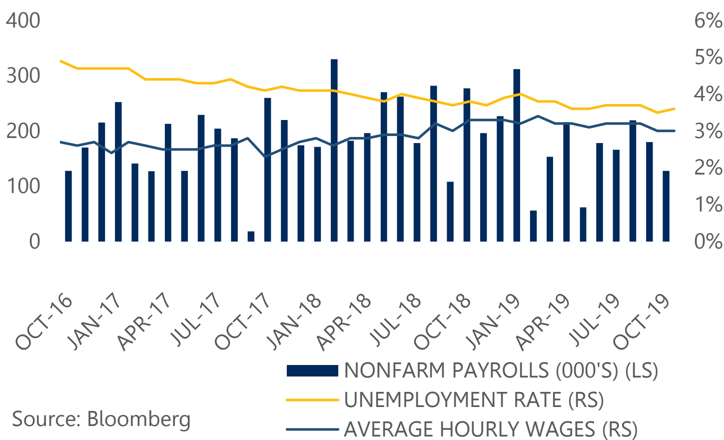


Source: Bloomberg

- Economic activity in the U.S. grew at an annualized rate of 1.9% in the third quarter, down slightly from the 2.0% pace in the second quarter. Better-than-expected growth was the result of continued strength in consumer spending as well as government expenditures.
- The Core Personal Consumption Expenditure (PCE) price index, the Fed's preferred inflation measure, rose 1.7% on a year-over-year basis in September, the slowest pace since 2016.
- The Core Consumer Price Index (CPI) which excludes volatile food and energy costs, rose 0.1% in September. The year-over-year reading for Core CPI remained at 2.4%.

LABOR MARKET

OCTOBER 2016 THROUGH OCTOBER 2019

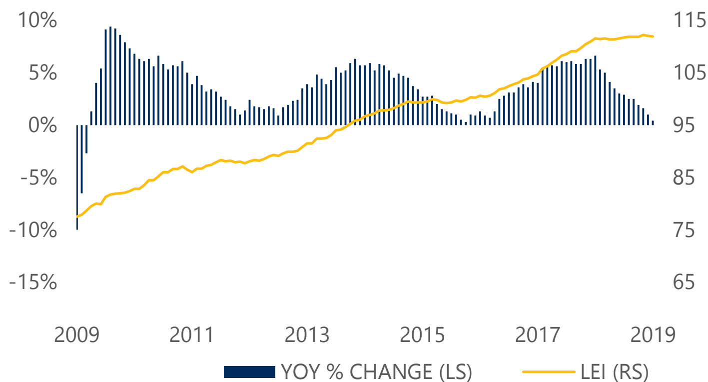


Source: Bloomberg

- Job growth in the U.S. has slowed in 2019, but October's employment report signaled that the labor market remains strong. Nonfarm payrolls increased by 128,000, easily topping economists' consensus estimate of 85,000. August and September payroll numbers were revised significantly higher by 51,000 and 44,000, respectively. The one-time impact of the General Motors auto worker strike, a reduction of 44,000 jobs, led to a net loss of 36,000 jobs in the manufacturing sector.
- A large influx in the labor force helped push the participation rate up to 63.3%, the highest level since 2013. As a result, the unemployment rate inched up from 3.5% to 3.6%. Average hourly earnings increased 0.2% in October, following no change in September, and rose 3.0% on a year-over-year basis.

LEADING ECONOMIC INDICATORS

SEPTEMBER 2009 THROUGH SEPTEMBER 2019



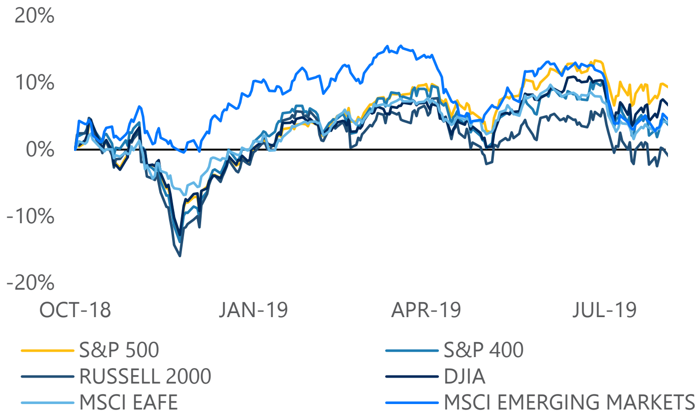
Source: Bloomberg

- In September, negative yield spreads coupled with soft manufacturing activity led to the U.S. Conference Board Leading Economic Index's (LEI) second consecutive monthly decline. The U.S. LEI dropped 0.1% to 111.9 for the month. Revised data showed a 0.2% decline in August and a 0.4% increase in July.
- The ISM New Orders Index and building permits were the most notable detractors and more than offset the positive contributions from the financial components.
- LEI's year-over-year growth continued to slow in September, coming in at just 0.4%; however, the data indicate a continuation in economic growth albeit at a slower pace. Positive U.S.-China trade war news, the third interest rate cut by the Fed this year, and U.S. equity markets reaching all-time highs may help the LEI strengthen next month.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, OCTOBER 2018 THROUGH OCTOBER 2019



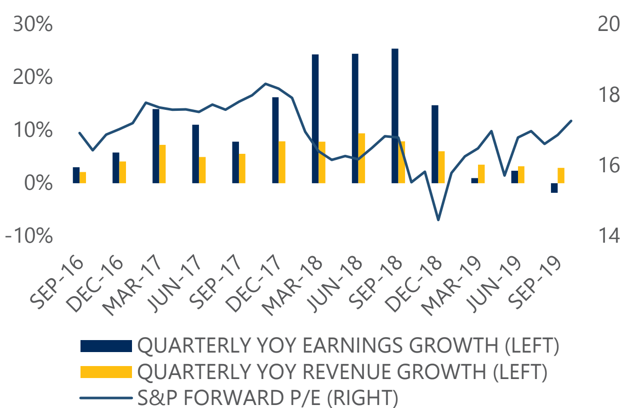
Source: Bloomberg

- In late October, the S&P 500 index reached a new closing high for the first time in three months and finished the month with a gain of 2.2%. Domestic equities were bolstered by better-than-expected third quarter earnings, U.S. and China agreeing to a partial trade deal, and the Federal Reserve's third interest rate cut this year.

- After trailing U.S. equities for most of the year, foreign equities outperformed in October. The MSCI EAFE and EM indexes gained 3.6% and 4.2% respectively. Foreign equities benefitted from the tentative U.S. and China phase one trade deal, an improvement in some eurozone economic data, Brexit's three-month extension, and a weaker dollar.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2016 THROUGH OCTOBER 2019



Source: Bloomberg

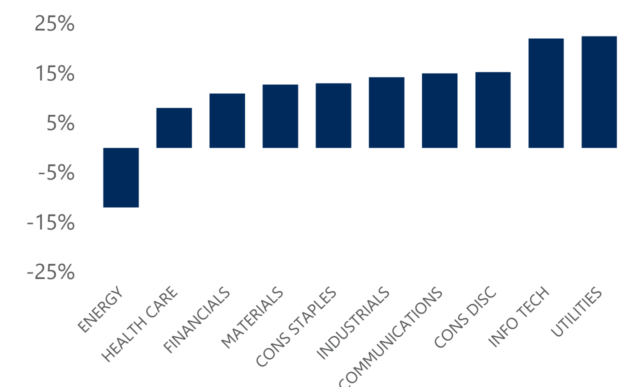
- Third quarter earnings growth appears to be unable to maintain the resiliency shown in the previous two quarters where growth remained positive despite analysts projecting declines. With over 75% of S&P 500 companies reporting, earnings are on track for a 1.9% contraction. This will be the first earnings decline since the second quarter of 2016.

- Analysts were originally projecting -3.6% earnings growth at the start of the reporting season. Revenue growth of 2.8% matched analysts' estimates.

- Analysts are forecasting an improvement in earnings growth next year to 9% due to easier year-over-year comparisons and modestly better sales growth.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

OCTOBER 2018 THROUGH OCTOBER 2019



Source: Bloomberg

- The health care sector led the S&P 500 higher in October with a 5.1% monthly gain, reversing its streak of three consecutive negative return months. The trend reversal was driven by surprisingly strong third quarter earnings growth of 9.6% compared to analysts' estimates for 2.4% growth.

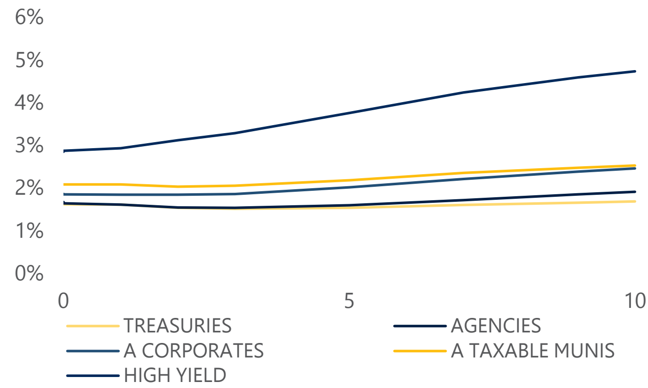
- Health care remains the second worst performing sector this year behind energy due to uncertainty of tighter health care regulation.

- The technology and communications sectors continued their strong uptrend this year as both sectors rose over 3.0% in October. Technology and communications gains of 36.5% and 25.4% in 2019 make them the first and third best performing sectors this year.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF OCTOBER 2019

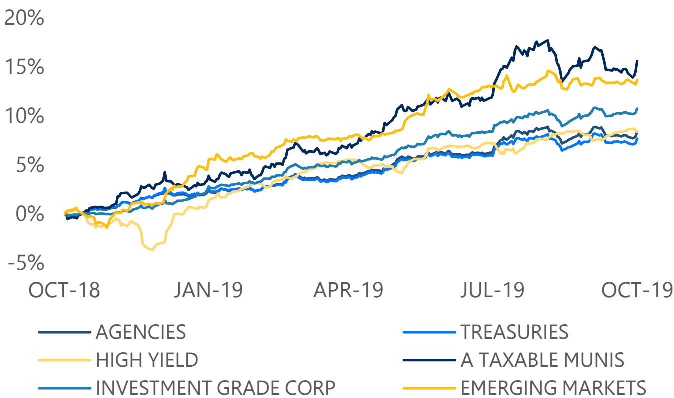


Source: Bloomberg

- Short-term U.S. Treasury bills with maturities less than one year experienced a significant decrease in yield in October, while U.S. Treasury bonds with maturities more than three years experienced an increase in yield, altering the yield curve closer to a normal or upward sloping shape.
- The U.S. 10-year Treasury yield moved above the U.S. three-month Treasury yield on October 10. This part of the yield curve had been inverted since May which fueled recession concerns. As of the end of October, the U.S. 10-year Treasury yields 17 basis points more than the three-month Treasury.
- Agency bonds' spread versus their Treasury counterparts begins to widen significantly around seven years out.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

OCTOBER 2018 THROUGH OCTOBER 2019

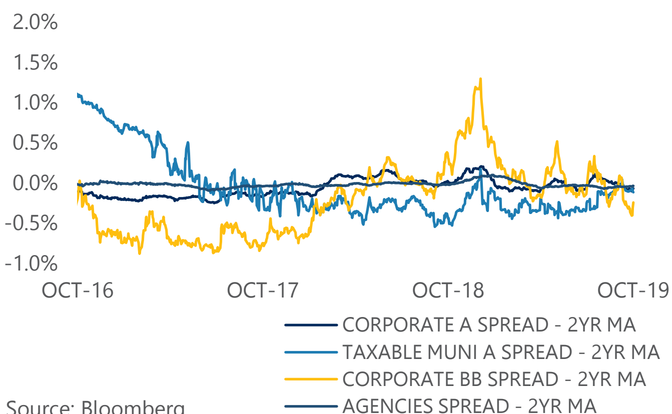


Source: Bloomberg

- Each of the fixed income sectors shown in the accompanying chart generated a healthy price return above 7.5% in the past twelve months as yields have continued to decline over the period.
- Each of the fixed income sectors has maintained a positive rolling one-year price return since January.
- Single A-rated taxable municipals posted the best one-year return of 15.6% while Treasuries recorded the weakest performance of 7.7%.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

OCTOBER 2016 THROUGH OCTOBER 2019



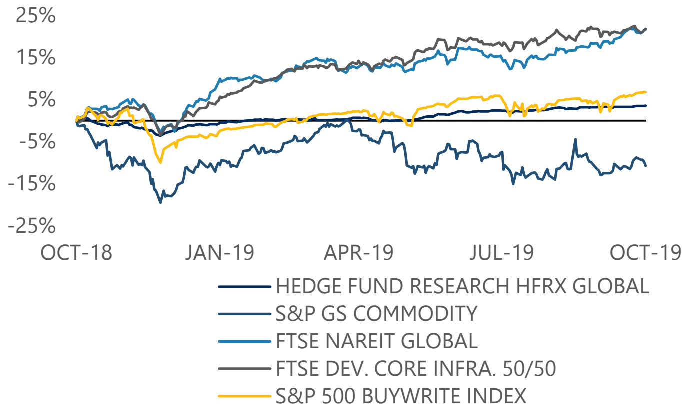
Source: Bloomberg

- The overall spread environment tightened in October as agencies were the only fixed income sector that saw spreads widen during the month.
- All fixed income sectors' spreads are currently below their two-year average spread.
- The two fixed income sectors with corporate credit exposure shown in the accompanying chart, Corporate A and Corporate BB, have negative spreads which signals that investors view corporate credit as safer than what it has been over the past two years.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

OCTOBER 2018 THROUGH OCTOBER 2019

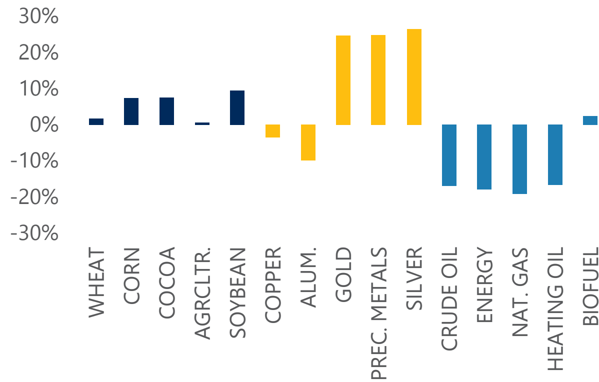


Source: Bloomberg

- Concerns about a global growth slowdown throughout 2019 have boosted yield-sensitive asset classes and weighed down economically sensitive areas of the market. The global real estate and developed market infrastructure indexes have outpaced the trade-weighted broad commodities index by more than 30% over the twelve-month period ending October 31.
- After climbing 19.3% in the first four months of 2019, the broad commodities asset class has declined 8.7% over the last six months.
- With the exception of gold prices, the broad commodities asset class will mostly likely struggle to achieve durable price gains without improvements in the simmering U.S.-China trade dispute.

COMMODITIES, 12-MONTH SPOT RETURNS

OCTOBER 2018 THROUGH OCTOBER 2019



Source: Bloomberg

- After peaking near $1,550 per ounce in the first week of September, gold prices maintained their level over the following eight weeks. In 2019, gold prices have been driven higher by catalysts including the Federal Reserve's three quarter-point interest rate cuts and lingering concerns about the prospect of recessions in key international economies.
- As more government bonds around the world price at negative yields, some market commentators have pointed to gold's zero nominal yield as increasingly compelling.
- Any signs of a pick up in U.S. inflation in the final months of 2019 could support further price gains for gold and boost crude oil prices.

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