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Investors Unfazed by Borrowing Increase

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Federal Reserve officials are concerned about the pace of corporate borrowing, but investors don't appear to be.

It is a disconnect that could cause investors pain if corporate balance sheets begin to show more cracks, a prospect that has some analysts worried.

In the minutes of the Fed's September meeting, released last week, some officials "expressed concern that the protracted period of very low interest rates might be encouraging excessive borrowing and increased leverage in the nonfinancial corporate sector."

Despite these worries, investors continue to demand corporate debt, helping fuel a years long rally in corporate credit that shows few signs of stopping. Corporate-bond issuance this year is set to total $1.5 trillion, nudging past last year's tally, according to the credit strategists at HSBC Holdings PLC, led by Edward Marrinan. Issuance of high-grade debt is expected to rise to another record this year.

It is a sign that, in the words of the bank's strategists, "Market participants seem to be downplaying—or looking past—the risks associated with the steady deterioration in the credit fundamentals of the U.S. corporate sector," such as rising leverage, contracting earnings and stressed revenue.

After the financial crisis, many companies focused on rebuilding their balance sheets to withstand another shock. But as the long period of low interest rates continued, cheap borrowing costs prompted more borrowing. Much of that went to fund shareholder-friendly activities like dividend increases and share buybacks. It also funded big mergers and acquisitions.

Even after sopping up all that debt, demand among investors has remained strong. Investors poured nearly $2.6 billion into investment-grade bond funds during the week ended Wednesday, the fourth consecutive week that inflows have exceeded $2 billion, according to Bank of America Merrill Lynch.

As the European Central Bank and Bank of Japan pushed interest rates below zero this year, dragging down corporate-bonds yields, foreign investors have fled into U.S. debt, according to HSBC's analysis of Treasury International Capital data, which shows a steady flow of money into corporate bonds from around the world. Investment- grade corporate bonds have returned 8.9% this year, while high-yield bond returns are at nearly 16%, according to indexes maintained by Bloomberg Barclays.
"Fast forward to 2016 and gross leverage is now markedly higher than it was in 2007, just before the onset of the 2008 credit crisis," said the HSBC strategists.

The problem is that the borrowing binge can't last forever, a worry that Fed officials flagged this week. As leverage keeps climbing, corporate balance sheets inch toward a breaking point. Already, the number of global corporate bond defaults ticked up to 133 so far this year, on pace to be the highest since 2009, according to S&P Global Ratings.