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Complacency is number one enemy of this ageing US credit cycle

The amount of US corporate borrowing should worry investors more than it does

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Buy low, sell high. Based on that dollop of investment wisdom, bonds across the risk spectrum have long faced an almighty reckoning.

Years of central banks suppressing both interest rates and market volatility will, at some point, start to swing back, sparking a scramble for the exit that risks a seismic event for the financial system.

Such ominous talk has stalked the great bond rally which peaked this summer when the universe of negative yielding debt approached an eye-popping $14tn. Notables such as Jeffrey Gundlach, Bill Gross and Ray Dalio of hedge fund Bridgewater have all recently warned about lofty valuations for bonds.

Now there is also growing unease from official quarters. The release last week ofFederal Reserve meeting minutes for September contained a gem buried deep within the usual policy conversations.

“A few participants expressed concern that the protracted period of very low interest rates might be encouraging excessive borrowing and increased leverage in the non-financial corporate sector,” the minutes said.

That followed a warning from the Office of Financial Research, whose twice yearlyfinancial stability monitor report from July noted: “Credit risks remain elevated in US non-financial businesses. The ratio of debt to earnings among firms has also approached or exceeded peak levels from past credit cycles, even for borrowers with investment-grade ratings.”

They are right to be worried.

Thanks to central banks being the biggest buyers of bonds, the suppression of yields has been a boon for share prices and for companies securing cheap sources of funding.

When bond yields set their lows for the year over the summer, the S&P 500 climbed to a record high, while the FTSE All World index set its peak for 2016. Share prices have been buoyed as their future cash flows become more valuable when evaluated on the basis of low interest rates.

This mutually reinforcing dynamic has been accompanied by companies selling debt and using the proceeds to buy back shares and hand out dividends. That is further bolstering asset values, fuelling a far bigger version of the credit and equity bubbles we saw back in 2000 and 2007.

While many look at China as the likely trigger of the next major housing debt and credit shockwave, US corporate debt issuance has been striking. Starting in 2012, annual sales of US investment-grade debt have topped $1tn, setting a record $1.23tn for 2015, according to Sifma. As of early October, investment-grade debt sales total almost $1.1tn, 9.7 per cent above last year.

In a low rate world, some argue companies have locked in long-term funding at cheap levels and can easily pay back what they owe. However, look beyond the top echelon of US companies, and the amount of cash held and the credit rating quality both slide.

S&P Capital IQ earlier this year noted that a record stash of $1.84tn in cash held by US non-financial companies masked a $6.6tn debt burden. They made the point that the concentration of cash of the top 25 holders, representing 1 per cent of companies, now accounts for over half the overall cash pile. That is up from 38 per cent five years ago.

Some such as Andrew Lapthorne at Société Générale reckon balance sheet crisis looms large for many companies, and a trigger will probably take the form of a sudden drop in share prices.

“Credit markets worry about debt as they are supported by equity values and volatility. If there is a sharp drop in share prices, credit spreads will widen a great deal even if a company can still pay the interest,” he notes.

The connection between bond yields and equities matters greatly. The rise in yields from their summer lows has been accompanied by share prices losing steam. Earnings need to rise as the help offered by low rates ebbs. The S&P 500 is virtually unchanged from May 2015, and is on track for a third straight month of declines.

An ageing US credit cycle increasingly reliant on elevated asset prices highlights the enormous challenge facing Fed officials as they look to tighten policy and wean markets off easy money. No wonder some are expressing concerns.

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