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The $29 Trillion Corporate Debt Hangover That Could Spark a Recession

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- Leverage at companies worldwide swells to highest in 12 years
- Capital not working hard enough at third of all firms

There's been endless speculation in recent weeks about whether the U.S., and the whole world for that matter, are about to sink into recession. Underpinning much of the angst is an unprecedented $29 trillion corporate bond binge that has left many companies more indebted than ever.

Whether this debt overhang proves to be a catalyst for recession or not, one thing is clear in talking to credit-market observers: It's a problem that won't go away any time soon.

Strains are emerging in just about every corner of the global credit market. Credit-rating downgrades account for the biggest chunk of ratings actions since 2009; corporate leverage is at a 12-year high; and perhaps most worrisome, growing numbers of companies -- one third globally -- are failing to generate high enough returns on investments to cover their cost of funding. Pooled together into a single snapshot, the data points show how the seven-year-old global growth model based on cheap credit from central banks is running out of steam.

"We've never been in a cycle quite like this," said Bonnie Baha, a money manager at DoubleLine Capital in Los Angeles, which oversees more than $80 billion. "It's setting up for an unhappy turn."

While not as pronounced as the rout in global equity markets, losses are beginning to pile up in the bond market too. The average spread over benchmark government yields for highly rated debt has widened to 1.84 percentage points, the most in three years, from 1.18 percentage points in March, according to Bank of America Merrill Lynch indexes. Investors lost 0.2 percent on global corporate bonds in 2015, snapping a string of annual gains that averaged 7.9 percent over the previous six years, the data show.

Debt at global companies rated by Standard & Poor's reached three times earnings before interest, tax, depreciation and amortization in 2015, the highest in data going back to 2003 and up from 2.8 times last year, according to the ratings company. Total debt at listed companies in China, the world's second-largest economy, has climbed to the highest level in three years, according to data compiled by Bloomberg.

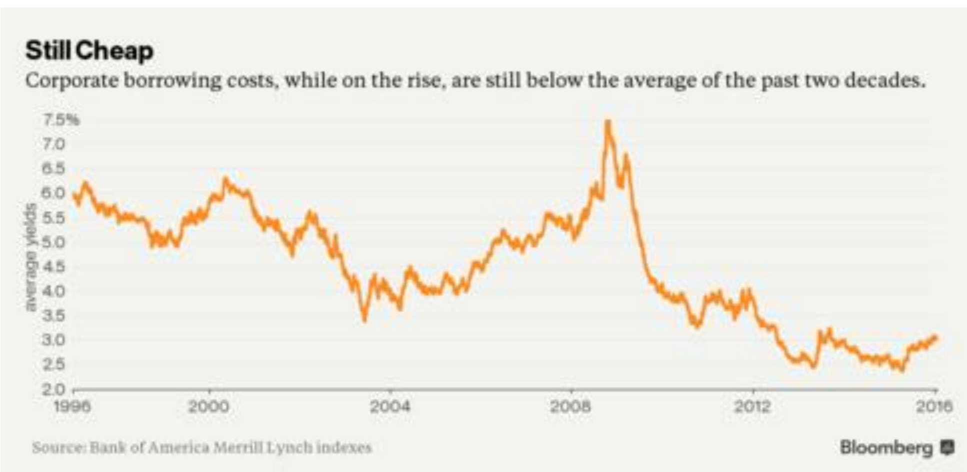
Worsening debt profiles contributed to S&P downgrading 863 corporate issuers last year, the most since 2009. More than a third of commodity and energy companies have ratings with negative outlooks or are on credit watch with negative implications, S&P said. Almost 6 percent of U.S. corporate bonds were downgraded through the third quarter, the largest proportion since 2009, according to Fitch Ratings. American, speculative-grade companies experienced downgrades totaling $94 billion compared to upgrades of $89 billion in the first nine months of 2015, Fitch said in a November report.

Much of the cheap credit accumulated by companies was spent on a $3.8 trillion M&A binge, and to fund share buybacks and dividend payments. While that tends to push up share prices in the short term, bond investors would rather see that money spent on strengthening the business in the long term.

Different Climate

"It's an indication we're in a different climate of expansion, rather than prudence, that targets shareholders and leverage," Jeroen van den Broek, head of developed-markets credit strategy and research at ING Bank NV in Amsterdam, said. "It's detrimental to credit holders."

That said, the U.S has borne the brunt of the downgrades and China's slowdown has been mostly felt in the commodities sector, indicating the impact on the global economy may be limited. S&P's global credit market outlook is stable and analysts estimate earnings will recover this year. Investment-grade firms have accumulated record amounts of cash, which will insulate them from market turbulence, according to a report from Citigroup Inc. this month.



Fragile Economy

"There are hairline cracks but it doesn't mean it's going to lead to cataclysmic global conditions in the credit markets," said Suki Mann, a former head of European credit strategy at UBS Group AG and founder of bond market commentator CreditMarketDaily.com. "Leverage is higher but it's only a problem if you can't service your obligation and the ability of investment-grade companies to service obligations is at a very good level."

At about 3 percent, overall borrowing costs for companies around the world remain below the average of 4.5 in the preceding two decades even as spreads have widened.

Still, for many in the market, the combination of high leverage levels and a sluggish global economy is a big concern. Growth across the world will be dragged down this year as China's slowdown prolongs the commodity slump and recessions endure in Brazil and Russia, according to the World Bank. It lowered its forecast for 2016 growth this month to 2.9 percent from a 3.3 percent projection in June. In comparison, the world economy advanced 2.4 percent last year, slower than the 2.6 percent expansion in 2014, the bank said.

Companies' debt costs are reaching new heights. As of the second quarter, high-grade companies tracked by JPMorgan Chase & Co. incurred $119 billion in interest expensesover the last year, the most for data going back to 2000, according to the bank's analysts.

Symptomatic Problem

The cost of raising and servicing capital is outweighing the returns companies get from it, a problem that Citigroup's Financial Strategy and Solutions Group said has affected one third of all companies -- the majority of which posted shortfalls in each of the past three years. The bank compared returns on invested capital with the weighted-average cost of funding among the more than 1,600 companies in the MSCI World Index in bank data going back to 2010.

The emerging cracks "are part of the same symptomatic problem -- an economy that's got stuck on stimulus," said Luke Hickmore, an Edinburgh-based senior investment manager at Aberdeen Asset Management, with about 284 billion pounds ($406 billion) of funds under management, according to its website. "It's not sustainable."