Written by Bob Adelmann on May 7, 2019

Fed Fears Rising Corporate Debt, Ignores Rising Federal Debt

For the second time in six months the Federal Reserve has issued a warning about excessive corporate debt. Its Financial Stability Report, released on Monday and issued twice a year, repeated its concerns over rising corporate debt burdens, particularly those being incurred by companies already carrying the most debt.

It said that "leveraged lending" — lending to companies whose debt already exceeds four times their earnings — jumped more than 20 percent last year. And since the first of the year, nearly 40 percent of those loans went to the most highly indebted companies — those with debt levels that exceeded six times their earnings.

Said the report: "Detailed balance sheet information of publicly traded non-financial firms reveals that, over the past two years, the firms with the most rapid increase in their debt loads have higher leverage, higher interest expense ratios, and lower cash holdings."

Part of the driving force behind this increased leverage is the increased hunger for yield from investors, mutual funds, insurance companies, hedge funds, and banks. As the Fed has kept interest rates abnormally low ever since the Great Recession, bond buyers were willing to take on extra risk to obtain higher yields.

And companies enjoying the good times — increased revenues, improved profit margins, expanding market shares — were only too willing to take advantage of those investors by issuing more bonds to satiate their mutual thirsts. Said the Fed in its report: "Investor appetite for risk appears elevated by several measures, and [consequently] the debt loads of businesses are [now] abnormally high … the most rapid increases in debt [are] concentrated among the riskiest firms amid signs of deteriorating credit standards."

That debt is either issued directly to bond mutual funds or grouped together in something called collateralized loan obligations or CLOs. Slices of those CLOs are then offered to hungry investors seeking yield through hedge funds, insurance companies, and banks. CLOs are sold on the basis that if one bondholder defaults it doesn't bring down the entire collection or group of bonds.

The trouble is, as the Fed pointed out, with something called a "liquidity mismatch." That occurs when an investor, or many of them all at once, decide they want their money back. The "secondary market" — the back door out — is very thinly traded and if the demand for funds grows, then the entity holding those CLOs must liquidate other assets to meet it. That is called the "domino effect" and was the basis for the film *The Big Short*, which revealed how it worked to trigger the Great Recession.

In fact, the Fed was forthright enough to make the comparison between today's levels of high-risk corporate debt and those just before the Great Recession. It said that credit standards have slipped since it issued its financial stability report last November, and that loans being made today to firms with especially high debt loads relative to earnings now exceed earlier peaks seen in 2007, just before the Great Recession.

The Fed governor heading up the committee that drafted the report, Lael Brainard, said that it "suggests stretched asset valuations and risky corporate debt merit continued vigilance" by the Fed's Board of Governors. The report itself said that "the elevated level of debt could leave the business sector vulnerable to a downturn in economic activity or a tightening in financial conditions."

This is "FedSpeak" for "recession." Janet Yellen, the former Fed chair, is now able to speak more plainly about the risks: "If the economy encounters a downturn, we could see a good deal of corporate distress. If corporations are in distress, they fire workers and cut back on investment spending. And I think that's something that could make the next recession a deeper recession."

The amount of "leveraged lending" the Fed is talking about amounts to $1.1 trillion. But nothing was said, either by the Fed or in the conversation surrounding the release of its report, about the "leveraged lending" the Treasury Department is involved in. Its job is to find buyers of more than $22 trillion in debt, increasing by $100 billion a month.

Applying the Fed's standards — debt that exceeds revenues by four times, or six times — the bonds issued by the Treasury must be considered as "leveraged lending" and are (or should be) likewise subject to the same concerns. With $22 trillion in debt and $4.75 trillion in revenues, the federal government's debt clearly qualifies.

And yet, according to the three credit-rating agencies — Fitch, Moody's, and Standard & Poor's — U.S. Treasury debt continues to earn their highest possible rating for safety and liquidity.

The only exception occurred once, and only once, when Standard & Poor's had the temerity even to suggest that U.S. government debt wasn't quite as secure as people wanted to believe. It downgraded its assessment of U.S. government debt from AAA by one notch, to AA+, four days after the 112th Congress voted to raise the debt ceiling in 2013 above the $14 trillion level.

The outrage that followed, from left and right, Democrat and Republican, led 18 days later to the head of Standard & Poor's, Deven Sharma, stepping down as CEO, and leaving the company altogether at the end of the year.

Now, with federal debt more than 50 percent larger, the silence about any concern over its safety and security is deafening. Instead the Fed is expressing its concern over a piddling trillion dollars that is being lent to companies with less than stellar credit ratings.

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