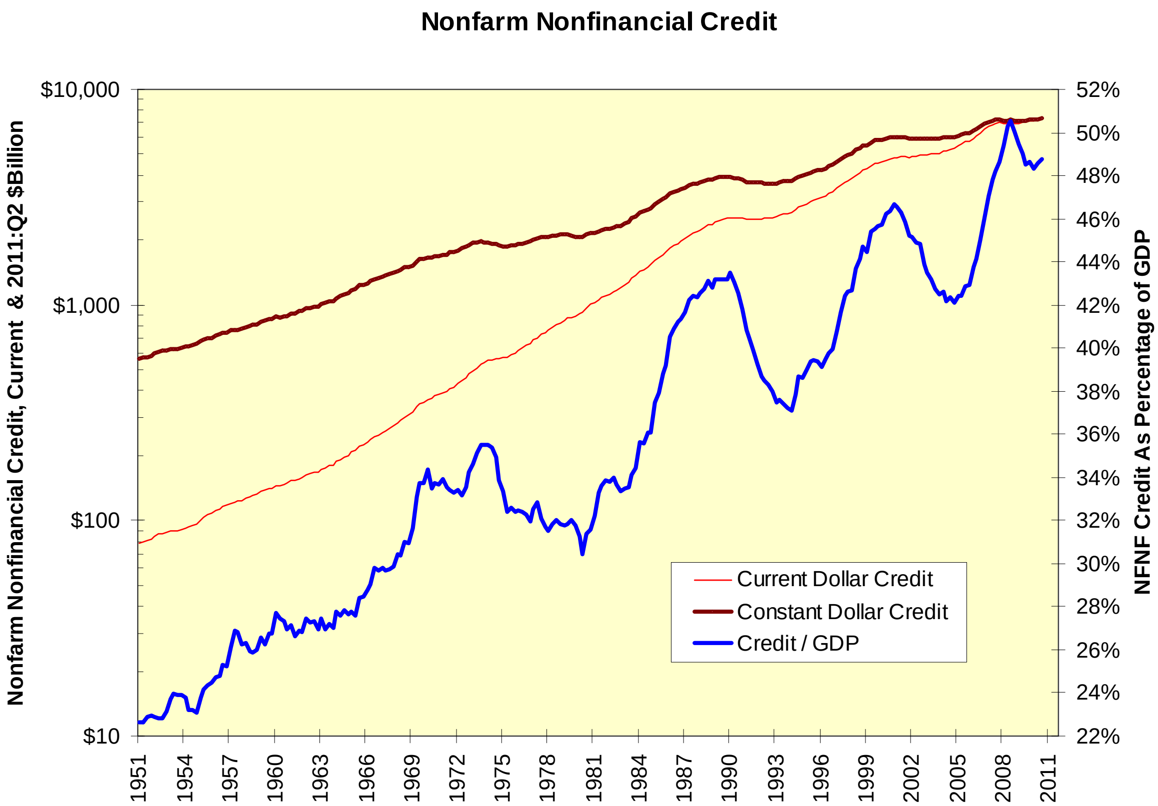
Corporate Leverage Remains High

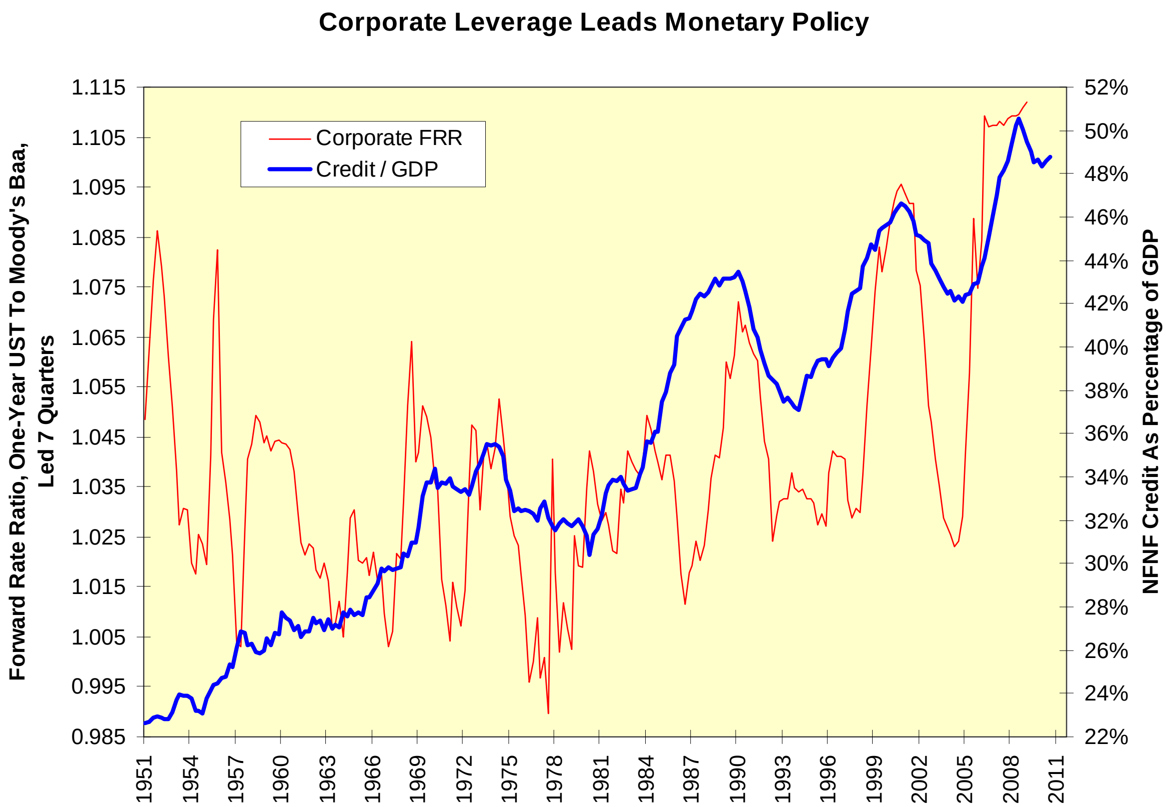
We will be celebrating Thanksgiving in about one month, which will give every family's designated uncle an opportunity to express himself on the great social issues of the day, such as why everyone but him is a lazy lout who expects things to be handed to him. Call it the Pilgrims' Revenge meets the Tea Party.

Every family's designated college student – they used to have names like Phoebe or Daphne back in my day but are no doubt Jennifer/Ashley/Stephanie/Lindsey today – will then educate the adult barbarians on the evils of capitalism, a lesson no doubt learned at some $50,000 per annum hideout from the real world. Call it Insufferability meets Occupy Wall Street.

Six decades worth of data on the leverage of nonfarm, nonfinancial corporations make it clear both sides are right, a conclusion sure to enrage them both before they get to the pumpkin pie, a dish inflicted on no one except on Thanksgiving. If we map the ratio of this debt to GDP since the Truman administration, we see a cyclic trend moving higher. The ratio peaked at 50.52% in the second quarter of 2009 and pulled back to 48.79% during the second quarter of this year.



The high and rising degree of leverage means the economy is increasingly susceptible to higher short-term interest rates; any increase in these rates reduces carry into corporate securities. We can illustrate this by mapping the ratio against the forward rate ratio (FRR) between one-year Treasuries and Moody's Baa-rated corporate bonds. This is the rate at which we can lock in borrowing from one year to the bonds' maturity, divided by the bonds' yield. The more this ratio exceeds 1.00, the steeper the yield curve and the more dependent it is on someone such as the Federal Reserve suppressing short-term interest rates. Right now, the FRR is at the steepest level on record.



The debt ratio actually leads the FRR by seven quarters on average. This means higher leverage tends to pull the FRR higher by virtue of some combination of higher corporate bond yields plus a monetary response whenever the corporate bond market starts to wobble.

This game has been going on for six decades through thick and thin. We have reached the limit of how far down we can push interest rates, and as the corporate sector is near its record level of leverage, we should assume it is highly vulnerable to any uptick in short-term interest rates for any reason. An unwinding of this domestic carry trade could, like an unwinding of the global dollar carry trade, lead to sharply higher interest rates on corporate bonds and lower multiples on stocks.

That will give everyone's bombastic relatives something to opine about, as if we do not have enough trouble in this world.