Private debt in US and China could amplify costs of the trade war

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Summary

- Private sector debt developments in the US and China probably won't trigger an economic crisis but could deepen a downturn, possibly triggered by the bilateral trade war.
- Lower profits, on top of more expensive funding despite monetary stimulus, might increase corporate distress and drag on investment.
- In the US, the real estate and utilities sectors are most vulnerable due to high indebtedness.
- The most exposed Chinese sectors are primarily the highly indebted firms in overcapacity commodities sectors as well as manufacturers operating in sectors targeted in the trade dispute.

The straw that breaks the camel's back?

The world economy's expansion is on increasingly shaky ground with risks stemming most significantly from its two largest economies. The US economy has now matched its longest period of consecutive growth on record, but uncertainty is increasing, bringing the Fed back to a defensive position. China's economic growth, while still robust in part thanks to government support, has slowed to its lowest rate since records began in 1992. What could be the trigger to knock either of these economies off course?

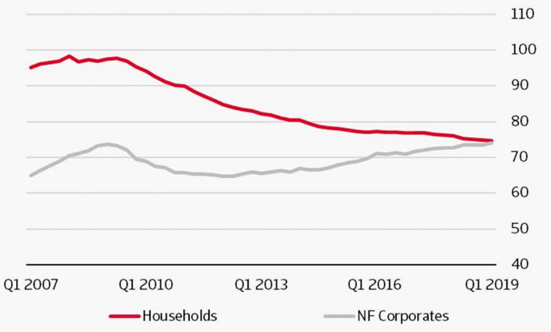
Private sector debt in the US was the key trigger of the global financial crisis in 2007, but at this juncture it is not sufficient for a repeat. The most glaring potential culprit now is the simmering trade war. While a truce barring further escalation of punitive tariffs was reached in June, the tariffs put in place thus far are estimated to cost the US 0.2% of GDP and China 0.5% (Oxford Economics). At this rate, that's not enough to knock either country into recession, but an escalation could. And private sector (corporate and household) debt in both economies could likely amplify this.

Higher tariffs translate into lower earnings, raising corporate debt distress and resulting in more layoffs and less investment. That amplifies the economic downturn and increases credit risk. As the composition of private debt in both economies has deteriorated in recent years, access to funding is becoming increasingly expensive for the highly leveraged firms amid global uncertainty – even in spite of loosening monetary policy by both Beijing and Washington.

US corporate debt above its pre-crisis peak

Private sector debt in the US has stabilised since 2016 at around 148% of GDP. However, this reflects diverging developments in household debt and non-financial corporate debt, which has resulted in a shift of risks from the household to the corporate sector. Whereas US households have continued deleveraging since the 2007-2009 financial crisis, US corporate debt has been expanding more rapidly than GDP (chart 1). At 74% of GDP in Q12019, it is historically high and slightly above its pre-crisis peak.

1 US households deleverage as corporates take on more debt
Private sector debt in % GDP



Source: IIF

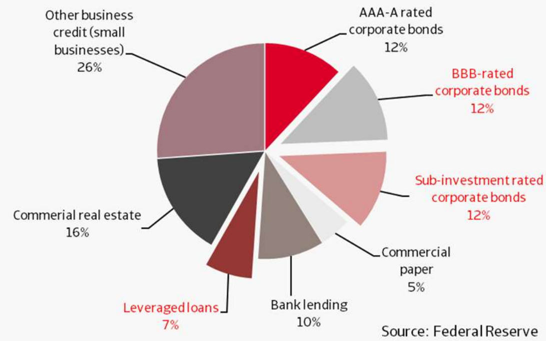
At this level, US corporate debt is still one of the lowest of advanced economies. However, most of the increase in US corporate debt since 2012 has not been used for growth-enhancing investments but instead has been given back to shareholders, through a combination of higher dividends, buy-backs and mergers & acquisitions (Economist, 16 March 2019). Moreover, concerns have risen about the quality of US corporate debt and the weakening of underwriting standards, particularly for higher risk corporate borrowers.

Debt composition has become riskier

US corporate debt is increasingly concentrated in the riskiest firms and in riskier forms of debt: lower-rated investment grade bonds (their share in total investment grade bonds went up from some 20% a decade ago to a little over 50% in 2018), speculative or high-yield bonds and leveraged loans, defined as lending to companies whose debt already exceeds four times their earnings before interest, tax, depreciation and amortisation (EBITDA). The share of these riskier forms of debt is now close to 30% of total US corporate debt (see chart 2). Moreover, the firms that experienced the highest increases in their debt loads have higher leverage, higher interest burdens and lower cash holdings compared to the average.

The risks have also shifted to the leveraged loan market. Leveraged loans have been the fastest growing component of US corporate debt, rising by 20% in 2018 and almost 16% on average in the past twenty years. Its share of total corporate debt stands at 7%, almost twice as high as that of the deep-junk rated corporate bonds. This rising demand for leveraged loans can be explained by Fed tightening since the end of 2015. In an environment of rising interest rates, investors prefer leveraged loans over high yield, as they provide a floating rate of interest, in contrast to bonds, whose coupons are fixed and whose value goes down when interest rates go up. In turn, as the Fed has changed course, investor demand for leveraged loans has been decreasing since March 2019, and investors have shifted to the high yield bond markets.

2 Riskier debt now accounts for nearly 30% of total US corporate debt
Composition of US corporate debt, % total, 2018 - riskier debt highlighted



Source: Federal Reserve

Fears of a repeat of the subprime mortgage crisis are overblown

These fears had increased because the volume of leveraged loans is now roughly the same as that of subprime mortgage debt in 2007 and of shared characteristics between the leveraged loan and subprime mortgage market: reduced incentives to monitor the creditworthiness of the obligor, weaker regulation, and increased securitisation of leveraged loans through collateralised loan obligations (CLOs). However, such are overdone. This is due to important differences: the CLO structures are much sounder than those used during the subprime mortgage credit bubble, the holders of the debt are different and more resilient, and the financial authorities now closely monitor financial stability vulnerabilities. The riskiest parts of the leveraged loans are primarily held by institutional investors and hedge funds, with banks only holding a relatively small portion and typically the highest quality securities. Based on the current information, the Fed therefore assesses risks to the financial system to be moderate.

But high levels of corporate debt could amplify an economic downturn

Rather than triggering an economic downturn, high levels of US corporate debt and particularly of leveraged loans could deepen the downturn if one were to be caused by another factor. Rising interest rates or falling corporate earnings are the two obvious ones. With the Fed currently in easing mode, falling earnings are the main threat. These could result from the escalation of trade tensions between the US and China. Although the US economy is experiencing its longest period of expansion, corporate profits seem to be feeling the impact of trade tensions: they declined by 3.1% in the first quarter of 2019. This was the largest decrease since Q4 of 2014.

Falling profits will make funding more difficult and raise corporate debt distress, resulting in higher layoffs and a cut back in investments. That will deepen the economic downturn once it occurs.

Moreover, despite the Federal Reserve moving towards an interest rate cut, yields for corporates with poorer credit quality have gone up. This effectively makes access to funding for highly leveraged firms more difficult. Even with an expansionary Fed, corporate distress may still rise due to the poorer credit quality in some segments of the corporate sector.

Although leveraged loan borrowers profit from an easing of US monetary policy, funding is becoming more difficult as investors are shifting to other assets. Also, of the risky debt types, the leveraged loans pose the biggest risk in the downturn. With interest amounting to at least half the pre-tax earnings of these leveraged loan borrowers, they are highly vulnerable to a drop in profits. The risk of fallen angels - a downgrade of BBB-rated corporations to high yield – seems to be manageable in the current environment of a more cautious Fed, according to rating agency Fitch. This risk was flagged earlier this year by the OECD, central banks and investors. But according to Fitch, US BBB-rated firms have sufficient financial flexibility to adjust their balance sheet. That said, certain pockets in the US market, could be vulnerable.

Most vulnerable sectors in the US

Firms operating in the utilities and real estate sectors are most exposed. They are the most indebted, with high debt/cash ratios of 30x and 16x respectively. 50% of companies in real estate have an interest coverage ratio (ICR) below two (a threshold for solvency risk). The real estate sector is most exposed to fallen angel risk, particularly the so-called real estate investment trusts (REITS). Other sectors with low interest coverage ratios are energy, communication services and health care. That said, large cash holdings in the healthcare sector provide a buffer against adverse shocks.

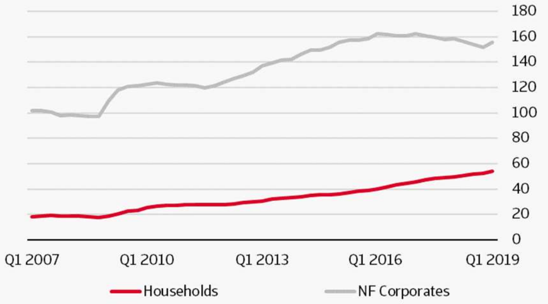
Other sectors that are highly exposed to fallen angel risk are food, beverages and tobacco, and building and construction. Finally, smaller US firms are particularly vulnerable to a slowdown in corporate earnings as the temporary boost to sales and earnings from earlier tax cuts fades. Most small-cap firms, and more than half by asset size, have interest coverage ratios below two.

China's financial vulnerability remains high

China's economy is slowing down amid its structural rebalancing from investment-led to consumption-led economic growth. As trade tensions worsen the slowdown in the manufacturing sector, Chinese authorities face a difficult trade-off between supporting near-term growth, countering adverse external shocks, and limiting its high dependence on debt through regulatory tightening.

3 Chinese corporates reverse deleveraging as household debt continues to rise

Private sector debt in % GDP



Source: IIF

Private sector debt in the China has only slightly declined since 2017 from 208% of GDP to 204% of GDP in 2018. As in the US, this reflects diverging developments between household debt and non-financial corporate debt, but in the opposite direction. Household debt has continued rapidly expanding whereas the corporate sector has been deleveraging in line with the economic rebalancing.

Rapid build-up of China's household debt warrants attention

Unlike in the US, China's household debt has expanded rapidly from 19% of GDP prior to the global financial crisis to 54% of GDP in Q1 2019 (chart 3) on the back of a rising middle class and exceeding the average for emerging markets of 38% of GDP. The near tripling of the household debt ratio is by far the fastest growth pace in the world. This warrants attention as in the past rapid debt build-ups have often coincided with a financial crisis. Meanwhile, household debt-to-disposable-income has risen even faster and is approaching advanced economy levels, now at almost 120% (from less than 30% in 2007). With 80% of household debt financed at floating rates, this makes Chinese households, particularly those of young people living in cities, more vulnerable to swings in the interest rate and the business cycle.

It might exacerbate an economic slowdown, as a slowing economy negatively impacts disposable income, meaning that a higher share will be needed for servicing the debt, thereby reducing household consumption. While the current stimulatory monetary measures mitigate these risks, the continuing increase in household debt warrants attention.

Earlier corporate deleveraging has hit private firms hard, exacerbating China's economic slowdown

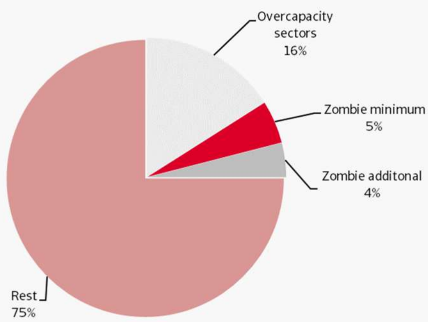
In contrast to developments in China's household debt, its corporate sector has started to deleverage, following the rapid build-up of debt, particularly between 2011 and early 2016 (see chart 3). Non-financial corporate debt moderately declined from its peak of 162% of GDP to 152% of GDP end-2018, but has ticked back up to 156% in Q1 of this year. Whereas state-owned companies (SOEs) accounted for most of the debt build-up, China's privately owned corporates were hit particularly hard by the deleveraging process. They rely heavily on the shadow banking sector for their funding. These shadow banks, a network of trust companies, fund managers and loosely regulated finance firms, reduced their activity and shrank over the past years from 87% of GDP end-2016 to 70% in September 2018 (Moody's). Since private firms are the main drivers of China's economic growth and job creation, the deleveraging process has exacerbated China's economic slowdown.

While credit quality has declined due to the high share of SOEs in China's corporate debt

Meanwhile at 156% of GDP, China's corporate debt is still the second highest among emerging markets, after Hong Kong (222% of GDP) and markedly above levels in the largest advanced economies (euro area, Japan, UK and the US). Unlike in many emerging markets, China's corporate debt is mainly denominated in local currency (95%), making it less vulnerable to exchange rate risk. Large cash holdings of many firms also mitigate risks. That said, like in the US, concerns have risen about deteriorating corporate credit quality. Corporate leverage, measured by corporate debt-to-EBITDA has jumped from 4x to almost 6x according to IMF data. Moreover, Oxford Economics mentions that the share of highly leveraged firms – with debt to earnings over 5x – has risen from 30% in 2007 to over 40% in 2017, the second highest of the main emerging markets and significantly above the G7 average of 30%.

The main factors contributing to the deterioration of the quality of debt of Chinese firms are the high share of SOEs in China's corporate debt and the presence of 'zombie' companies (source: IMF Working Paper, November 2017). The IMF and IIF estimate that SOEs account for over 55% of corporate debt while the OECD estimates it at over 80%. The difference is most likely related to the extent to which state-controlled firms are incorporated next to entirely state-owned firms. These SOEs have higher liabilities compared to their profits (15x compared to 5x for private firms). Loss-making 'zombie' companies and companies in overcapacity sectors – defined as steel, aluminium, coal, plated glass and cement – accounted for 20% to 25% of total corporate debt at the end of 2017 according to the IMF (see chart 4; the share of zombie debt is estimated to be between 5% and 9%). Nearly half of this 'zombie' debt is on SOEs (IMF, 2017).

4 Up to 25% Chinese corporate debt is higher risk
Composition of Chinese corporate debt, % total, 2018



Sources: IIF and IMF

Private sector 'zombie' firms are the most vulnerable to deteriorating conditions. But concerns about government support of SOEs is rising, especially following the first offshore default by an SOE, Qinghai Provincial Investment Group, in north-western China last year. The policy shift on bailouts positively shows that Chinese authorities are addressing the 'zombie' debt at SOEs particularly at the central government level.

Corporate debt dynamics increase risk of hard landing of China's economy

China's economy is slowing down as a consequence of the transition from export- and investment-led growth to domestic, consumption-driven growth. However, Beijing's financial deleveraging campaign and the US import tariffs also have their impact. To avoid a hard landing, the government cut taxes and eased monetary policy in a targeted way. This has cushioned the downturn, but growth in Q2 still slowed to 6.2%, the slowest pace in almost three decades. Moreover, these policies to counter the economic slowdown have caused corporate debt to begin ticking back up to record levels in Q1 2019. This underlines the authorities' limited room for manoeuvre to cushion the economic slowdown in the short term as it increases longer-term risks to financial stability. As in the US, the high corporate debt and its deteriorating quality could amplify this downturn, making it harder to avoid a hard landing. Note that while profits at Chinese private firms grew 6.6% year-on-year in January-May 2019, those at SOEs fell 9.7%. Declining profits could make financing more difficult, raise debt distress, result in more lay-offs and less investment and could as such amplify the downturn.

Most vulnerable sectors

The most vulnerable sectors in China are the overcapacity sectors: steel, aluminium, coal, plated glass and cement, together with construction and real estate. Property developers are the most indebted. Traditional manufacturers and sectors caught up in the US-China trade dispute are also directly exposed, as they are struggling to get access to credit. Intermediate and capital goods are the primary goods targeted by US tariffs, thus affecting sectors like metals, plastic, and machinery. These sectors have seen their sales to the US drop by 20% to 40%, whereas sales to the US are up 12% in sectors that are unaffected by the tariffs.

Private debt risks amplifying trade war effects

The US and China, the world's two largest economies, remain engaged in a trade dispute that could de-stabilise their economies. Developments in private debt may be the straw that breaks the camel's back. It amplifies the economic costs of a downturn through the elevated credit risk and corporate distress. Moreover, the associated risks remain high even in the face of government support to cushion the ongoing downturns, as access to finance remains expensive for firms with poor credit quality.

The risks private debt poses in a downturn are increasing, but a crisis stemming directly from private debt is not imminent. Risks are mitigated in both countries by the stock of corporate debt being primarily denominated in local currency. Furthermore, better household finances in the US could also insulate the economy from a sharp slowdown. In China, gradually rising household debt could increase vulnerability to business and credit cycles, but thus far, government support is helping to mitigate this. But that very support is putting corporate debt back on an upward trajectory.

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