Is America's Mountain of Corporate Debt Too Big to Climb?

At a recent speaking event, former Federal Reserve Chairman Janet Yellen sounded the alarm about corporate debt. In the event of an economic downturn, she warned that the current levels of corporate debt could make the next recession more severe and prolonged, even leading to corporate bankruptcies.

In the years since the since the financial crisis, low interest rates and easy lending standards have sent the amount of corporate debt skyrocketing. When the Great Recession began in 2007, total debt for non-financial corporations was about $4.9 trillion. As of late 2018, it has surged 86 percent, to a total of $9.1 trillion, according to data from the Securities Industry and Financial Markets Association. In the next four years, as much as $4.8 trillion of that corporate debt is scheduled to mature. If we see an economic deceleration in that time, some corporations may find themselves unable to service such massive debt obligations.

At current levels, corporate debt is equal to 45 percent of total U.S. GDP. Every major recession since the 1980s has coincided with a high debt-to-GDP ratio. The current debt-to-GDP ratio is higher than it was before the dot-com bubble of 2000 or the housing crash of 2007. The problem is not isolated to just America. According to the Organization for Economic Cooperation and Development (OCED), global corporate debt reached almost $13 trillion at the end of 2018. Corporate debt in emerging markets, driven primarily by China, has increased by 395 percent in the last decade.

It is not just that there is so much more corporate debt, but much of it is has a low credit rating. The last decade has seen a dramatic increase in corporate bonds rated BBB, just one level above being considered high-yield, or "junk." From 2007 to 2018, BBB-rated bonds increased by 330%, or from $800 billion to $3.4 trillion. A recent report from credit rating agency Fitch Ratings notes that 59 percent of all corporate bonds have a BBB rating. They estimate that in the case of an economic downturn, anywhere from $105 billion to $215 billion of BBB bonds could be downgraded, losing their “investment-grade” status, increasing these bonds’ rates and, potentially, defaults. Such a massive influx of junk bonds could also destabilize the $1.2 trillion junk bond market.

Still, there is reason to be optimistic. Recent GDP data shows that the American economy is more resilient than the rest of the globe, and, thus far, corporations have been able to service their debts. In fact, Fitch is predicting that 2019 will have the lowest level of corporate bond defaults in more than five years. Furthermore, new issuances of corporate bonds have slowed, meaning that corporations are not racking up new debt at the pace they have been. Still, the potential for a corporate debt bubble remains, and it is important to protect your portfolio in case the bubble bursts. Diversification is key, and any investments in corporate bonds should be allocated to high-quality investment-grade bonds and companies with sound balance sheets.