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$22 Trillion … and Counting

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I realize I often quote a small handful of experts in this column, and certainly one of those is Jeffrey Gundlach of DoubleLine Capital sometimes referred to as "The Bond King". That is a little odd since bonds are certainly not my forte, however, many times I will read one of his interviews and think to myself, "that is exactly what I was thinking", thus here we are because he did that again recently.

In an interview from just a few days ago, Gundlach expressed concerns over both growing corporate debt as well as the U.S. Government's growing national debt, which recently topped **$22 trillion…** a new record that will certainly be broken the next time it is tallied.

As Gundlach and others have pointed out recently (but have been beating the drum about for some time now) the national debt is becoming the elephant in the room. What is perhaps most alarming is the degree to which it has grown despite a now decade long expansion. Presumably, the debt situation should be more tenable when things are good because more people are working and contributing to the tax rolls, and by extension, fewer are utilizing government entitlements, which should mitigate outlays. It begs the question, which Gundlach essentially raised, if the national debt is increasing/accelerating during "good times" what is it going to do when things turn south?

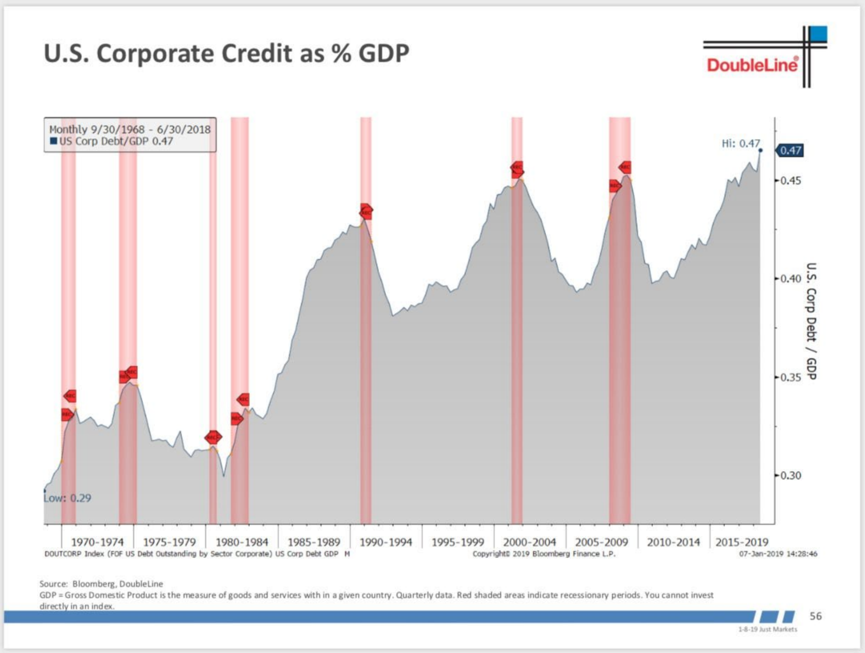
As Gundlach opined:

> *"If we're growing [debt] at 6% of GDP, which is what we're really growing at in terms of national debt during fiscal 2018, during a 3% real economy, then what's the debt going to grow by during a recession?" he said. "Well typically, the debt-to-GDP ratio goes up about four percentage points during a recession. So, it suggests the national debt would grow at around a 10% annual rate if we go into a normal average type of recession.* ***That's obviously a really big problem."***

Gundlach also notes that increasing the deficit in the face of rising interest rates was a "suicide mission". That may explain at least some of the Fed's recent tightening pause. Make no mistake, the impact of higher rates on the federal deficit are telling. However, despite the Fed's posture, it makes one ponder just how long the U.S. can keep expanding deficit borrowings without the market demanding higher rates? Further, it seems like a certainty to me that deficit headwinds are going to be increasingly problematic for economic growth, which leads us to Gundlach's next issue.

Along with government debt, Gundlach also noted that corporate debt is sounding the alarm. To that end, he cited the following:

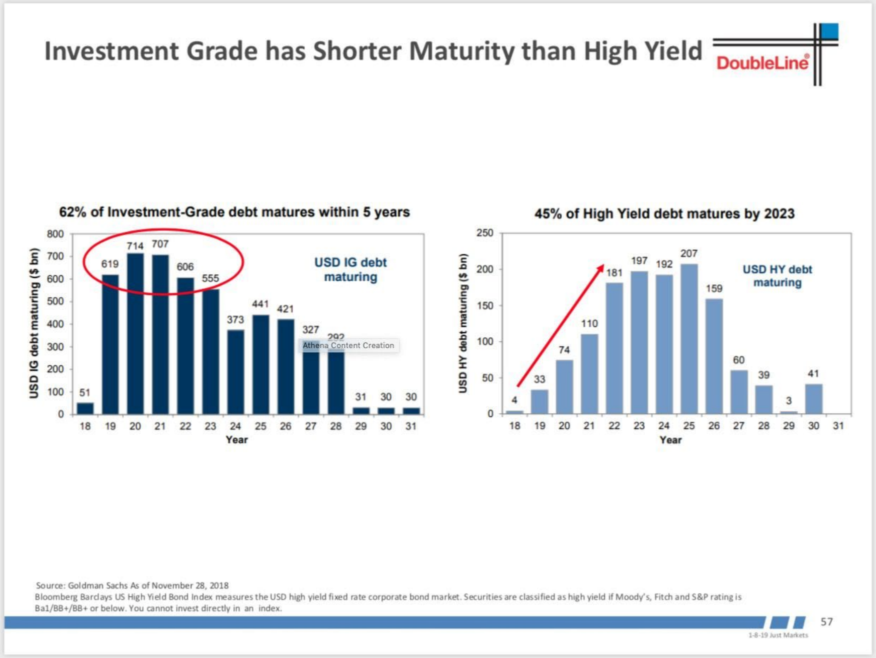
"…a study conducted by Morgan Stanley, notes that if you were to use leverage ratios alone (and he characterized leverage ratios as the "most important" variable when rating debt) ***45% of the investment grade bond market would actually be rated junk".*** He highlighted the risks by providing the following chart, which frankly paints an ominous picture for today:



U.S. Corporate Credit as % GDP

Source: Bloomberg, DoubleLine
GDP = Gross Domestic Product is the measure of goods and services with in a given country. Quarterly data. Red shaded areas indicate recessionary periods. You cannot invest directly in an index.

In another presentation, Gundlach referenced some information from Goldman Sachs that illustrated that while only $51 billion of Investment-Grade corporate debt matured in 2018, in 2019 14X that amount will mature ($714 billion). Moreover, debt maturities for the following three years thereafter will all top $500 billion:



Investment Grade has Shorter Maturity than High Yield

Source: Goldman Sachs As of November 28, 2018
Bloomberg Barclays US High Yield Bond Index measures the USD high yield fixed rate corporate bond market. Securities are classified as high yield if Moody's, Fitch and S&P rating is Ba1/BB+/BB+ or below. You cannot invest directly in an index.

That brings me to my final point, which I have taken aim at in this column in the past; corporate stock buybacks.

Don't misunderstand, I am not on the face opposed to stock buybacks. I think stock buybacks are entirely prudent when managers conclude that the prevailing market price(s) of their shares do not reflect their fair value, and as such purchasing back shares is an appropriate use of *excess cash*. However, at least conceptually, that also suggests that management may not see significant opportunities to deploy cash *back into the enterprise* and garner favorable returns. That may speak to their ability to grow the business in general. Here again, that may simply be the case (they are having difficult finding attractive uses for capital that can result in favorable rates of return), however, as I have sited on various occasions, many of the companies issuing massive buybacks **are still trading at hefty multiples**, which is not exactly congruent with businesses that are having trouble finding opportunities to grow. Moreover, in many of those instances, the buybacks are hiding some of their lack of growth by simply reflecting lower comparative share counts. I would argue that if one really wants to look at a company's profit growth, they should start with operating income.

As an extension, and more to Gundlach's concerns, corporate debt is currently pushing all-time high's not only in real terms but as also as a percentage of GDP. Circling back to my comment about "prudent" buyback decisions, while using "excess cash" to buy-back shares at prices management deems to be undervalued is one thing but borrowing cash to buy back shares at multiples that by some relative measures are the highest some of these companies have seen is quite another. Perhaps this is more coincidental than I think, but it seems telling to me that the expansion of the Fed's balance sheet aligns closely with the amount of stocks repurchased by major corporations over the years. Obviously, that notion is far simpler than the exact reality, but I don't think it is a stretch to suggests that a considerable amount of the Fed's liquidity has ended up on the balance sheets of corporations who clearly did not use it to make capital improvements, grow their businesses and/or enhance productivity. I think the aggregate numbers of each of those items generally bears that out. The trouble is, unlike the equity that debt effectively replaced, the debt must be repaid, and the chart above provides some color on exactly when that must happen. Moreover, paying off a fixed debt when some of these businesses are effectively shrinking seems problematic to me, and certainly not a scenario that supports higher valuation multiples.

Unfortunately, the stock buyback craze is also beginning to be challenged by another element that could lead to far reaching changes in the practice. We are starting to see politicians largely (but not exclusively) from the left suggesting that buybacks need to be regulated. As much as I think some stock buybacks deserve scrutiny, I cannot begin to express what a misguided idea government regulation is. I feel confident that market forces will ultimately determine the merits of all these buybacks, but government regulation would be a disastrous, intrusive, slippery slope … among other bad labels. I cannot fathom people thinking that is a good idea, on the other hand, I cannot fathom replacing airplanes with high speed rails or tearing down and reconstructing every building in the U.S., or paying people wo don't choose to work either…so what do I know? If we think the deficit is a problem now, wait until we start giving the Federal Government even more things to "fix".

Clearly, debt expansion in the U.S. (and across the globe for that matter), has raised a red flag amongst some, while others (if extended equity multiples are any indication) don't seem to think it matters much. I tend to be in the first camp, while apparently, the majority appears to be in the latter. I just hope we are not fiddling as Rome burns… or at least smolders.