EDITORIAL

US: ECONOMIC RESILIENCE DESPITE HIGHER RATES. THE ROLE OF COMPANY FINANCES (PART 1)

In the US, in an environment of aggressive monetary tightening, the resilience of companies has contributed to the resilience of the economy in general through various channels -staffing levels, investments, growth of profits and dividends, etc.-. Companies' resilience has been underpinned by different financial factors: company profitability, cash levels accumulated during the Covid-19 pandemic, the ease of capital markets-based funding, low long-term rates that had been locked in during the pandemic. Finally, the growing role of intangible investments also plays a role because they are less sensitive to interest rates, thereby weakening monetary transmission.

Despite significant and swift increases in official interest rates, judging by e.g. real GDP growth and the labour market, the US economy has been remarkably resilient during this monetary policy cycle. After analysing the role of household finances in last week's *EcoWeek*[1] we now turn to companies. Through various channels -staffing levels, investments, growth of profits and dividends, etc.- they have contributed directly or indirectly to the resilience of the US economy in general. After the rebound following the collapse during the pandemic, company investments have been growing in recent years at about 5% y/y, a pace that was maintained despite the huge increase in official interest rates (chart 1). It raises the question of what has been underpinning this resilience of companies. Our analysis will focus specifically on financial factors.

A first factor has been company profitability. Chart 2 shows that profits per unit of real value added have been volatile during the latest tightening cycle but, contrary to previous cycles, they didn't decline. This may be related, amongst other factors, to stronger pricing power and productivity gains. One can suppose that this has had a positive influence on the confidence of corporates and their shareholders as well as on their access to financing. A second factor has been the cash levels accumulated during the Covid-19 pandemic due to the public policy support and the strong economic recovery that followed. Economists at the Federal Reserve Bank of Boston found that "*firms used the cash accumulated in 2020 and 2021 to increase investment, intangible assets, payouts (dividends and buybacks), and operating expenses during the current tightening cycle without issuing any additional debt*.[2]" When the authors published their article in October 2023, they were concerned about the depletion of corporate cash holdings -which would force companies to increase the use of (expensive) external funding to finance investments- but the latest data show that the cash holdings have rebounded. In the fourth quarter of 2023, they were again close to the peak reached after the Covid-19 pandemic (chart 3). A third factor behind the resilience of companies has been the ease of capital markets-based funding. The corporate bond spread peaked in the summer of 2022 -although the Federal Reserve was still in the early phase of its rate hike cycle-, reflecting that yield hungry investors were not too concerned about default risk.

This cushioned the impact of the ongoing rise in Treasury yields on the total borrowing cost -Treasury yield + corporate spread- of companies issuing debt. Interestingly, bank lending conditions continued to tighten subsequently, giving rise to a negative correlation with the corporate bond spread, a phenomenon not seen in previous cycles (chart 4). The fourth factor was the record fixed-rate debt issuance by firms during the pandemic. This allowed companies to lock in low long-term rates and reduced their sensitivity to the Fed's monetary policy[3].

Finally, a fifth factor is the growing role of intangible investments. Prior to 1980, US companies invested predominantly -about 90 percent- in tangibles (physical capital goods including buildings). Since then, the share of intangibles investment -software, research and development (R&D), entertainment and artistic products- has tripled to almost 30 percent of all investment spending[4]. This influences the transmission of monetary policy. Research by the IMF shows that "total investment in firms with more intangible assets responds less to monetary policy, and that intangible investment responds less to monetary policy compared to tangible investment[5]." Two reasons are given for this result. "*Firms with intangible assets use less collateral* [6]*, and therefore respond less to the credit channel of monetary policy*[7]*. Second, intangible assets have higher depreciation rates, so interest rate changes affect their user cost of capital relatively less*.[8]" The impact of the shifting composition of corporate investment -less tangibles, more intangibles- is significant and "may have dampened the investment response to monetary policy by almost 30%[9]." Whether this resilience can last in a 'high rates for longer' environment will be discussed in the next issue of *EcoWeek*.

William De Vijlder

1 *US: economic resilience despite higher rates. The role of household finances* (bnpparibas.com), 14 May 2024.
2 Source: Falk Bräuning, José L. Fillat, and Gustavo Joaquim, *Firms' Cash Holdings and Monetary Policy Transmission,* Federal Reserve Bank of Boston, Current Policy Perspectives, 12 October 2023.
3 Source: *Financial stability report,* Federal Reserve, April 2024.
4 Source: Cooper Howes and Alice von Ende-Becker, *Monetary Policy and Intangible Investment,* Federal Reserve Bank of Kansas City Economic Review, second quarter 2022.
5 Source: Robin Döttling and Lev Ratnovski, *Monetary Policy and Intangible Investment*, IMF Working Paper, August 2020.
6 Intangibles are financed primarily using internal funds or equity.
7 The credit channel of monetary policy refers to the increase in information frictions when monetary policy is restrictive. In such an environment, lenders need to spend more time analysing the credit quality of borrowers, thereby incurring higher costs, which is reflected in the interest rate they charge. Source: Ben Bernanke and Mark Gertler, Inside the black box: the credit channel of monetary policy transmission, National Bureau of Economic Research, working paper 5146, June 1995.
8 The user cost of capital corresponds to the interest cost and the depreciation rate. When the latter is high compared to the former, interest rate changes have a more limited impact on the user cost of capital.
9 Source: Joel M. David and François Gourio, *The rise of intangible investment and the transmission of monetary policy,* Federal Reserve Bank of Chicago, ChicagoFedLetter, Number 482, August 2023.

COMPANY INVESTMENTS AND FEDERAL FUNDS RATE

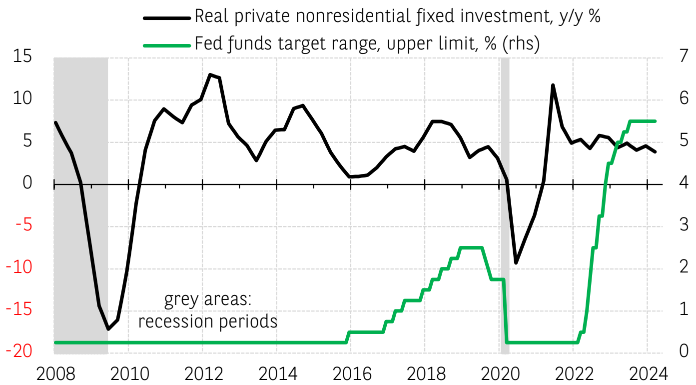

CHART 1

SOURCE: BEA, FEDERAL RESERVE, BNP PARIBAS

COMPANY PROFITS

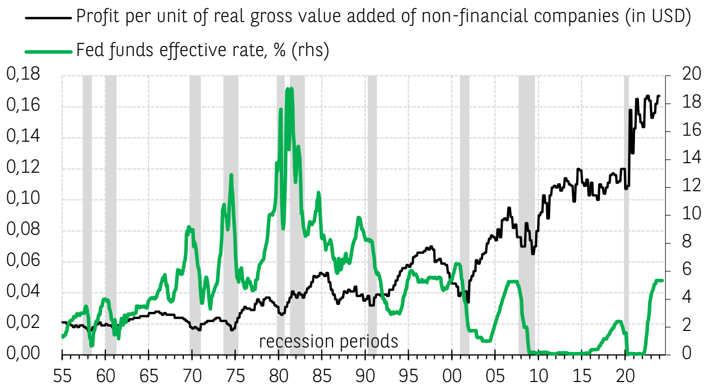

CHART 2

SOURCE: BEA, FEDERAL RESERVE, BNP PARIBAS

LIQUID ASSETS OF NONFINANCIAL COMPANIES

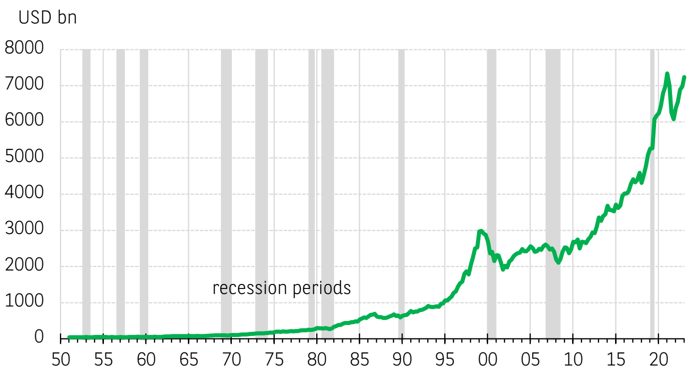

CHART 3

SOURCE: FEDERAL RESERVE, BNP PARIBAS

US: CORPORATE BOND SPREAD AND BANK LENDING CONDITIONS

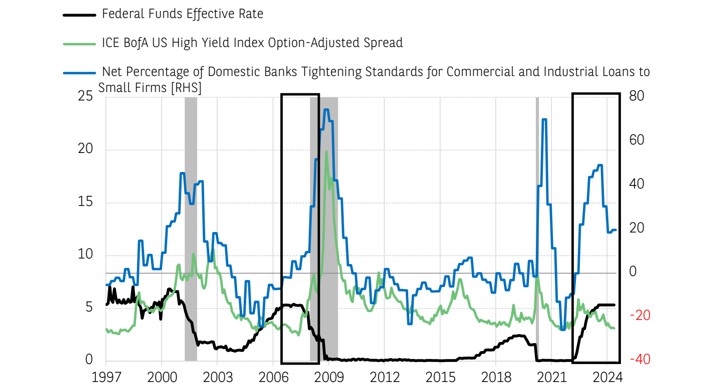

CHART 4

SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS, BNP PARIBAS