US: ECONOMIC RESILIENCE DESPITE HIGHER RATES. THE ROLE OF COMPANY FINANCES (PART 2)

Faced with a significant increase in official interest rates, companies have been surprisingly resilient. Can this last in an economy which is bound to slow given the 'high policy rates for longer' environment? The Federal Reserve's latest Financial Stability Report gives some comfort based on a comparison of corporate bond yields and spreads to their historical distribution. Moreover, resilient earnings imply a robust debt-servicing capacity. Does this assessment hold in a stress test scenario? A recent analysis of the Federal Reserve concludes that the debt-servicing capacity of the U.S. public corporate sector as a whole is robust to sustained elevated interest rates, unless in case of a severe economic downturn. Unsurprisingly, firms with balance sheets that are already weak, are far more sensitive to persistently higher interest rates or a severe drop in growth. Such a development might have repercussions for the broader economy through client-supplier relationships, the labour market and, possibly, a contagion effect in corporate bond markets.

As discussed in the previous issue of *EcoWeek*[1], faced with a significant increase in official interest rates, companies have been very resilient thanks to several financial factors: 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. The growing role of intangible investments also plays a role because they are less sensitive to interest rates, thereby weakening monetary transmission.

Can this resilience last in an economy which is bound to slow given the 'high policy rates for longer' environment? The Federal Reserve's Financial Stability Report[2], which was published in April, gives some comfort. Yields for both investment and speculative grade bonds stand near the median of their respective historical distributions. Corporate bond spreads narrowed to levels that are low relative to their historical distributions. The excess bond premium -which measures the difference between corporate bond spreads and expected credit losses- remains near its historical mean. Moreover, interest coverage ratios (ICRs)—earnings before interest and tax divided by interest expenses— point to "*robust debt-servicing capacity, reflecting resilient earnings*."

Nevertheless, going forward, close monitoring will be necessary considering that the economy is slowing -as shown by the decline in the hiring rate and the growth of nonfarm payrolls- whereas due to the stickiness of inflation, the FOMC argues it is in no hurry to cut rates. Besides, according to the Federal Reserve, "*expectations of year-ahead defaults remained somewhat elevated relative to their history*", and vulnerabilities of unlisted small and middle-market firms are inching higher. In addition, there is still a concern about the delayed effect of past increases in the federal funds rate. Last year, an analysis of the Federal Reserve Bank of Boston[3] noted that historically, the pass-through of higher official rates into firms' interest expenses occurred with a delay of about five quarters because the share of corporate debt that is floating-rate debt is relatively small, so the pass-through depends on the fixed-rate debt that matures and needs to be refinanced.

This delay would imply that interest charges are bound to increase considering that the FOMC has hiked its policy rate until its July meeting last year. In such case, in the coming quarters, there could still be a more significant negative impact of high interest rates on investment and hiring decisions. Access to financing could also become more difficult because "*many debt contracts include financial covenants that require firms' performance metrics to meet certain thresholds, so higher interest expenses can lead to firm distress and, if the covenants are violated, actual defaults.*" A recent analysis of the Federal Reserve Bank of Kansas City[4] provides detailed estimates of the large amount of fixed-rate debt that will mature in the next few years. This debt will need to be refinanced at rates that are significantly higher than before. Yet, the authors conclude that "*most firms have healthy interest coverage ratios, suggesting they can likely weather higher debt servicing costs as long as their earnings remain stable.*"

The words 'as long as' remind us of the interdependencies between policy rates, borrowing costs, company sales and earnings, interest coverage, hiring decisions, etc. Add to these factors the delayed pass-through effects of past rate hikes as well as the heterogeneity amongst companies in terms of financial resilience and it is clear that assessing whether the current resilience can last is a huge challenge. A recent publication[5] of the Federal Reserve goes a long way in providing an answer. It uses interest coverage ratios (ICRs) to assess the sensitivity of U.S. nonfinancial public firms under several macroeconomic scenarios developed by Moody's, taking into account projections of corporate earnings growth, Treasury yields, bond spreads, the federal funds rate, the growth of corporate bonds and loans outstanding as well as the debt maturity structure and hence future refinancing needs of firms.

The authors conclude that thanks to strong balance sheets and moderate refinancing needs in the short run, "*the debt-servicing capacity of the U.S. public corporate sector as a whole is robust to sustained elevated interest rates, both in the soft landing (baseline) scenario as well as in a stagflation scenario with a moderate economic downturn.*"

1 US: economic resilience despite higher rates. The role of company finances (part 1) (bnpparibas.com), 22 May 2024. In addition to corporate resilience, households' resilience is also noteworthy and contributed to the strong performance of the US economy (US: economic resilience despite higher rates. The role of household finances (bnpparibas.com), 14 May 2024).
2 Source: Board of Governors of the Federal Reserve System, Financial Stability Report, April 2024.
3 Source: Falk Bräuning, Gustavo Joaquim, and Hillary Stein, Interest Expenses, Coverage Ratio, and Firm Distress, Federal Reserve Bank of Boston, Current Policy Perspectives, 29 August 2023.
4 Source: Huixin Bi, W. Blake Marsh, and Phillip An, Corporate Interest Expenses Are Expected to Increase Further, Economic Bulletin, Federal Reserve Bank of Kansas City, 2 February 2024.
5 Kadyrzhanova, Dalida, Ander Perez-Orive, and Eliezer Singer (2024). «Stress Testing the Corporate Debt Servicing Capacity: A Scenario Analysis,» FEDS Notes. Washington: Board of Governors of the Federal Reserve System, 9 May 2024.

This also applies, on average, to the non-investment grade firms. However, a severe economic downturn would, through a sharp decline in earnings, "*lead to a substantial deterioration in the projected aggregate ICR to levels similar to those observed in the 2008-09 and 2020 recessions*" (chart). Finally, focusing on firms with balance sheets that are already weak, persistently high interest rates would lead to a meaningful deterioration in their credit quality. This would also apply to "*some large investment-grade (IG) firms that have so far been relatively insulated from rising rates by their high share of fixed-rate debt.*" In such a scenario, the share of debt at risk[6] would see a sustained increase over the next two to three years even if earnings remain resilient.

There is a concern that such a development might have repercussions for the broader economy when financially stressed firms cut back on hiring and spending, thereby impacting households and suppliers. In addition, there is a risk of a contagion effect whereby rising corporate bond spreads of stressed issuers would trigger a widening in the spread of higher quality issuers.

William De Vijlder

PERCENTAGE OF DEBT AT RISK OF US LISTED NONFINANCIAL FIRMS

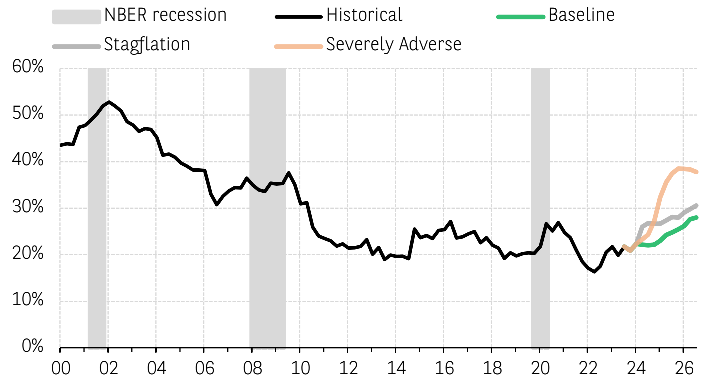

CHART 1

SOURCE: FEDERAL RESERVE, NBER, BNP PARIBAS

> US firms with balance sheets that are already weak are far more sensitive to persistently higher interest rates or a severe drop in growth. Such a development might have repercussions for the broader economy through client-supplier relationships, the labour market and, possibly, a contagion effect in corporate bond markets.

6 The percent of debt at risk is the percent of debt with ICR < 2.