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Economics Group

Interest Rate Weekly

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Financing Growth: Success at the Corporate Level

While the current economic recovery has been characterized as a shortage of credit, bond issuance and bank loan growth have been solid for the non-financial sector—while leverage-on average-remains modest.

High Grade Bond Issuance, What's the Return?

For the current economic recovery and into expansion, the issuance of high-grade debt has been much stronger than prior to the Great Recession (top graph).

On the supply side, non-financial firms certainly have an incentive to issue debt with borrowing costs at record lows. But also recall that the borrowed money must be put to good use. The balance that needs to be achieved is between a low cost to borrow and the expected rate of return on investing that capital. Yet, given the constant refrain about a "weak" economic recovery, many firms are able to find opportunities for investment that meet the borrowing hurdle. On the demand side, investors flock to high-grade debt, given their perception that the investment return on the debt, adjusted for the perceived level of risk, is an attractive investment. Finally, there is an attractive rate of return relative to sovereign debt, for example, U.S. Treasury debt.

High Yield Issuance: Tracking Equity Returns

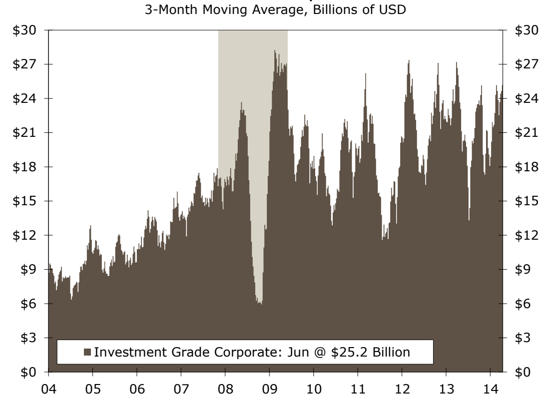
For high yield bonds, the strong pace of issuance (middle graph) follows the pattern of high grade debt. The reasons for this pattern are similar in part as well. For companies, there is the incentive to finance debt at low rates while perceiving that there is a profitable opportunity to invest those funds. For investors on the demand side, there is an attractive yield, adjusted for risk, relative to other debt—especially sovereign debt. What remains interesting is that so many firms are willing to issue debt in an environment where so many commentators decry the lack of growth. This suggests that many business leaders do see opportunity, perhaps more on the global front, than those who focus only on the developed markets. Over time, the perception is that the performance of the high yield market tends to follow that of the general equity market, and so, that pattern appears to be in place in this cycle as well.

Leverage: Remarkably Low

Despite the increase in debt issuance and the perception of weak economic growth, interest expense as a percent of pre-tax profits remains quite low given the historical experience (bottom graph). In part, this is a result of the very low level of current interest rates and the strong pace of corporate profit growth in recent years.

In the months ahead, we expect that interest rates will rise and profit growth will slow and yet we do not expect that credit conditions for non-financial corporations will deteriorate significantly—on average. Certainly there may be some companies that have leveraged too much given their profit prospects. However, for the overall non-financial sector, we do not foresee that a rise in rates or a slowdown in profit growth over the next year will pose a significant risk to the overall economy.

Investment Grade Corporate Issuance
3-Month Moving Average, Billions of USD



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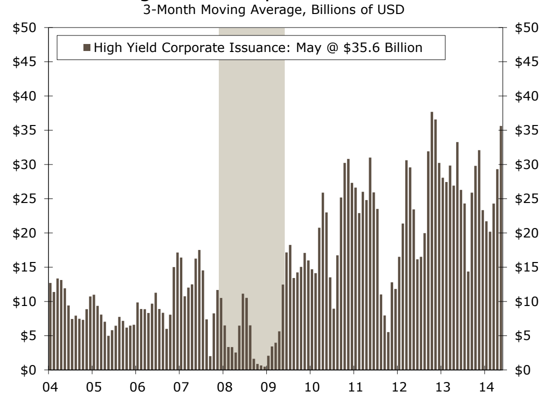
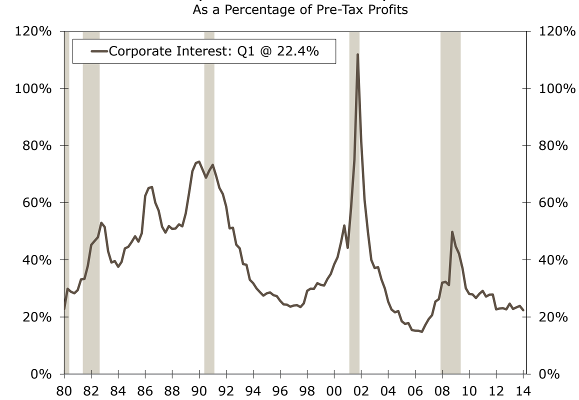


Non-Fin. Corporate Business: Corporate Interest
As a Percentage of Pre-Tax Profits



Source: IFR Markets, U.S. Department of Commerce and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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