OECD sounds corporate debt warning

By Nick Beams
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The Organisation for Economic Cooperation and Development (OECD), the 36-member body covering the world's major economies, has issued a report detailing the rapid rise of corporate debt and the dangers its poses for the world economy in the event of an unexpected rise in interest rates or a recession.

It found that at the end of 2019 the global outstanding stock of non-financial corporate bonds had reached an all-time high of $13.5 trillion.

The OECD pointed to an "unprecedented build-up of corporate bond debt" since the financial crisis of 2008 and an increase of $2.1 trillion in 2019 alone due to the easier monetary policies pursued by the US Fed and other major central banks over the past year.

Its conclusions were based on a dataset of more than 92,000 corporate bonds issued by companies in 114 countries between 2000 and 2019.

The report found that in comparison to previous credit cycles "today's stock of outstanding corporate bonds has lower overall rating quality, higher payback requirements, longer maturities and inferior investor protection."

It noted the significant impact of the US Fed's reversal of its monetary policy at the start of last year. In 2018 the US had lifted interest rates four times and was on course to continue this policy in 2019 in an effort to "normalise" monetary policy following more than a decade of ultra-low rates and quantitative easing in the wake of the 2008 crash.

However, Wall Street staged a rebellion in December 2018, with the largest falls for the month since 1931 in the midst of the Great Depression. The Fed immediately reversed course, shelving its plans for further increases and cut rates three times last year—a U-turn that was followed by major central banks around the world.

After decreasing in 2018, the issuance of corporate bonds jumped to $2.1 trillion in 2019, equalling the previous record high reached in 2016.

The spike is part of a longer-term trend. Since 2008, the annual global issuance of bonds has averaged $1.8 trillion, twice the annual average between 2000 and 2007. High levels of indebtedness were identified as one of the causes of the financial meltdown of 2008, but since then debt has increased.

Not only has the quantity of debt escalated, the quality has decreased. In every year since 2010 about 20 percent of all bonds issued has been non-investment grade (that is, so-called junk bonds) rising to 25 percent in 2019. This is the longest period since 1980 that the proportion of non-investment grade has been so high, an indication that "default rates in a future downturn are likely to be higher than in previous credit cycles," the OECD report noted.

It also pointed out that the portion of BBB-rated bonds—the lowest level that enjoys investment-grade status, rose to 51 percent in 2019, compared to 39 percent in the period 2000-2007.

Lower quality bonds now dominate the total stock, it said. Last year only 30 percent of outstanding non-financial corporate bonds were rated A or above.

The length of debt maturity is also increasing, leading to potentially greater instability. "As longer maturities are associated with higher price sensitivity to changes in interest rates, the combination of longer maturities and declining credit quality has made bond markets more sensitive to changes in monetary policy," the report said.

It also pointed to another significant trend—the move by non-financial corporations into financial markets. It noted that between 2009 and 2018 the value of corporate bond holdings by 25 large non-financial US companies tripled from $119 billion to $356 billion, with the company with the largest portfolio holding $124 billion in corporate securities.

Commenting on the report, OECD secretary-general

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Angel Gurria said the high levels of leverage in the corporate sector "make it essential to put in place reforms that make all parts of the capital markets fit for purpose."

"This must include steps to improve the ability of equity markets to strengthen corporate balance sheets and support long-term investments," he said.

But there is no sign of such "reforms" taking place. This is because increasingly the corporate debt market is not being used to finance investment in the expansion of investment and production. Rather, in conditions of ultra-low interest rates, debt is more and more being used by companies to finance share buybacks to boost the value of the company's shares—one of the chief means by which wealth is siphoned to the upper reaches of the financial oligarchy.

Organisations such as the OECD always try to use the most measured language when pointing to the dangers inherent in the operations of the financial system. The report said the concentration of outstanding bonds "just above the demarcation line between investment and non-investment grade status may lead to substantial sell-offs that put corporate bond markets in general under stress, giving rise to stability concerns."

The tone was relatively muted but the message was nonetheless clear—the escalation of debt, fuelled by the monetary policies of the world's major central banks, is creating the conditions for another financial meltdown.

The OECD is not the only organisation warning of the growing dangers in global debt markets. Last year an advisory report by the Robert Triffin International forum to the G20, the details of which became public last month, raised similar concerns.

"The risk of an unexpected and unplanned reversal of abundant global liquidity hangs over the world economy. Strong contagion across markets could make the endogenous dynamics of global liquidity very dangerous," it said.

The decade of ultra-low interest rates and quantitative easing had created a situation where the world was awash with debt denominated in US dollars with no guarantors standing behind this debt.

The report noted that as the experience of 2008 had shown "the supply of private liquidity cannot be relied upon in periods of stress." The official sources of liquidity such as IMF reserves, central banks swap lines and the euro zone bailout fund may not be sufficient if there is a scramble for US dollars in a period of crisis.

Government debt is also on the rise. Last week the rating agency S&P Global said it expected governments around the world to borrow the equivalent of $8.1 trillion in 2020, a 20 percent jump on the levels of 2015.

By the end of the year it forecasted government debt to reach a record $53 trillion, a 30 percent increase in the past five years.

Signs of the crisis pointed to by the OECD emerged last week when rating agencies cut the rating on the bonds of the US food giant Kraft Heinz to below the investment grade threshold, making it the largest so-called "fallen angel" in 15 years.

The Lex column in the *Financial Times* warned bluntly: "Expect more dropouts from the heavenly host."

Such downgrades can have a cascading effect when investors are forced to sell the bonds of such "fallen angels" because their mandates require that they not hold non-investment grade debt.

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