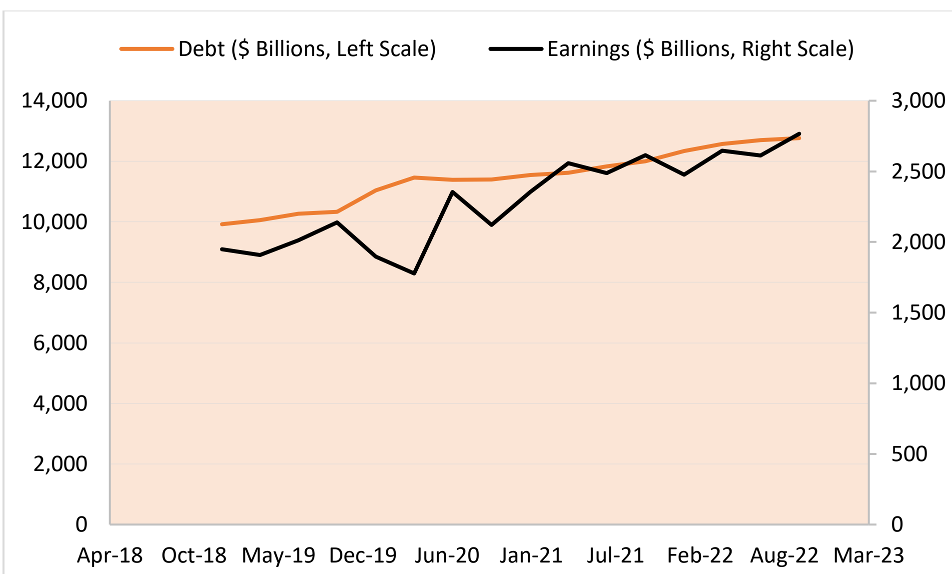
May 2023

Rising Interest Rates May Squeeze Corporate Profit

American corporates piled on a ton of debt during the pandemic. Non-financial corporate businesses added $2.5 trillion in debt over the last three years and now owed a staggering $12.7 trillion.[1] Given rapidly rising interest rates—and no clear end in sight, it seems inevitable that higher borrowing cost would eventually start to squeeze corporate profit.

Some may find comfort in the fact that corporate earnings have by and large kept pace with debt, except for the first few months of 2020 when earnings fell off the cliff. See Figure 1. For the period 2019-2022, for every dollar of debt, non-financial corporate businesses have generated earnings (before interest and taxes) of 20 cents, on average.[2]

Figure 1: *Non-Financial Corporate Businesses Debt and Earnings: 2019-2022*

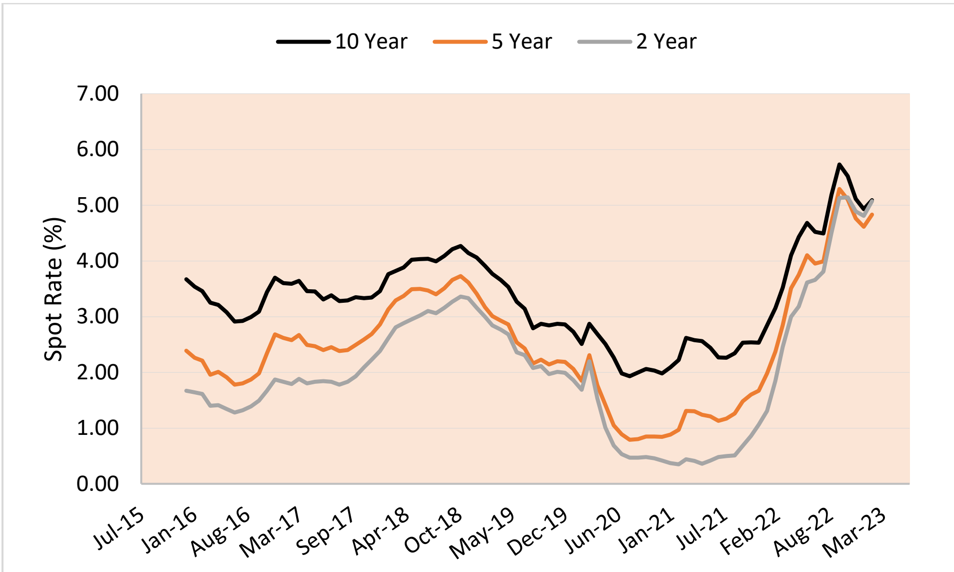


[1] Board of Governors of the Federal Reserve System (US), Nonfinancial Corporate Business; Debt Securities and Loans; Liability, Level [BCNSDODNS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BCNSDODNS, April 2, 2023.

[2] Board of Governors of the Federal Reserve System (US), Nonfinancial Corporate Business; Earnings Before Interest and Tax (FSIs), Transactions [BOGZ1FA106110115Q], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BOGZ1FA106110115Q, April 3, 2023.

Corporate borrowing cost have risen furiously in 2022, as shown in Figure 2, which plots the yields on High Quality Market (HQM) corporate bonds with three different maturities.[3] Since HQM bonds comprise of mostly investment-grade bonds, the spike in their yields in recent months suggests that even for the most credit-worthy companies, the day of cheap credit is likely behind us.

Figure 2: *High Quality Market Corporate Bond Yield*[4, 5, 6]



Corporate bond spread, which is the difference between corporate bond yield and the yield on treasury bond with the same maturity, has also spiked in 2022. In other words, lenders are attaching a higher risk factor to corporate borrowers and accordingly demand a higher interest rate for compensation, compared to the return on risk-free treasury securities. For example, the 10-year corporate bond-treasury spread hovered around 100 bps for the most part since 2018 (except for the early pandemic months) but has risen by as much as 75 bps during 2022. The spread has retreated in early 2023 but remains significantly above historical average.

For additional inquiries, please contact info@vegaeconomics.com.

[3] The HQM yield curve uses data from a set of high-quality corporate bonds rated AAA, AA, or A that accurately represent the high quality corporate bond market. <https://fred.stlouisfed.org/series/HQMCB2YRP>.

[4] U.S. Department of the Treasury, 2-Year High Quality Market (HQM) Corporate Bond Par Yield [HQMCB2YRP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/HQMCB2YRP, April 3, 2023.

[5] U.S. Department of the Treasury, 5-Year High Quality Market (HQM) Corporate Bond Par Yield [HQMCB5YRP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/HQMCB5YRP, April 3, 2023.

[6] U.S. Department of the Treasury, 10-Year High Quality Market (HQM) Corporate Bond Par Yield [HQMCB10YRP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/HQMCB10YRP, April 3, 2023.