Balance sheet basics: when buybacks bite

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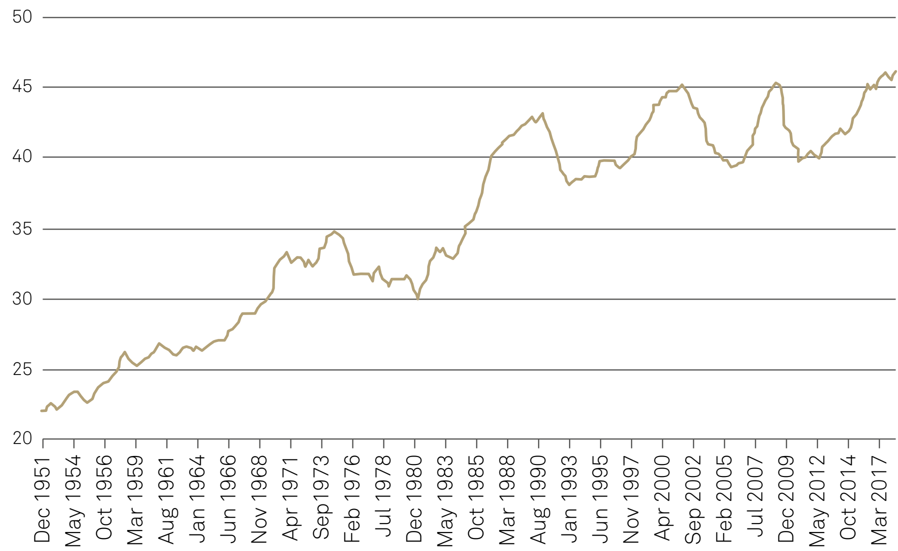
The 10-year anniversary of 2008's global financial crisis has served to remind us that we have been living with extraordinary monetary policy for nearly a decade and this period of easy money/liquidity has distorted markets and economies in profound ways.

These ways will not be fully appreciated until, to paraphrase the words of Charlie Prince, (former CEO of Citi Group), the music stops. It is broadly recognized that central bank asset purchases have inflated asset prices but what is less well recognized, is how financial repression has led to an apparent improvement in fundamentals that is likely to prove far more ephemeral than many anticipate.

One of the ways central bank liquidity has distorted economies/markets has been by inflating corporate credit. By buying up government bonds and effectively making them unavailable to the market, central banks have forced investors to move out along the risk curve in an attempt to unlock the yield they require. Increased demand for corporate credit has pushed down the interest rate corporates have had to pay to issue debt and the lower cost of credit has made debt-for-equity swaps a no brainer for any management team remunerated on their ability to create 'shareholder value'. Consequently, many corporates have issued debt in order to fund share buybacks and by reducing the number of shares outstanding, management teams have been able to boost earnings-per-share (EPS) at a faster rate than organic profit growth. Meanwhile, the market has duly bid up the price of the shares to reflect the higher EPS, earning management teams handsome rewards.

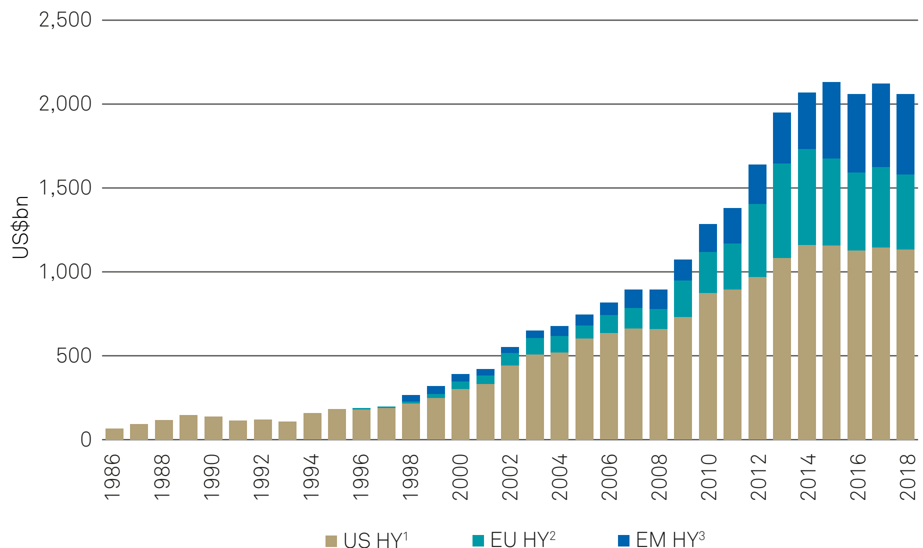
However, while this may have been an attractive strategy for companies in the low growth post-crisis world, such financial engineering is not without consequence. Equity is the component within a company's capital structure that makes it more resilient to financial and economic volatility, but a higher leverage ratio has precisely the opposite effect; making corporates more financially vulnerable to economic volatility. To this point, as the world's major central banks increase interest rates and China slows in response to tighter monetary policy, global growth is slowing and the risks are rising for those companies that have most readily embraced higher leverage ratios in order to engineer a higher share price. With no sign that policy makers are about to relent, the outlook is likely to become more challenging for such companies, and in this environment, it will be those companies that can demonstrate that they have the most solid corporate balance sheets that will fare best through 2019.

U.S. NON-FINANCIAL CORPORATE DEBT AS A SHARE OF GDP (%)



Source: Newton, Bloomberg accessed as at October 25, 2018.

GROWTH OF HIGH YIELD BOND/LOAN MARKETS



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, S&P LCD, June 30, 2018.

1 U.S. HY: The BofA Merrill Lynch U.S. High Yield Index tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

2 EU HY: Bank of America Merrill Lynch European High Yield Index tracks the performance of Euro denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets.

3 EMHY: The BofA Merrill Lynch Diversified High Yield US Emerging Markets Corporate Plus Index is comprised of U.S. dollar-denominated bonds issued by non-sovereign emerging markets issuers that are rated below investment grade and issued in the major domestic or eurobond markets.

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