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ECONOMIC RESEARCH REPORT
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December 14, 2018 • 630.517.7756 • www.ftportfolios.com

Yellen Agrees with The Austrians

In a recent interview, former Fed Chair Janet Yellen warned that excessive corporate debt could exacerbate the pain of the next economic downturn. The argument goes that if something triggers a slowdown in the economy, and companies' sales decline, their higher debt service burdens will force them to lay off employees and shrink investment which could cause a sputtering recovery, or even a recession.

The strange thing about this argument is how quickly Yellen changed her mind. Back in June 2017, when she was still Fed chair, Yellen stated "I don't believe we'll see another financial crisis in our lifetime." Since her departure from the Fed, the pace of actual rate hikes - as exposed by the Fed's dot plots - has been adjusted upwards under Jerome Powell by only 25 basis points. This is an insignificant change and makes us think these comments have more to do with politics and no longer being in power than her being truly concerned with cracks in the system.

What's even more confusing is that expanding credit to increase corporate borrowing is straight out of Yellen's own Keynesian playbook. This was the entire idea behind QE and the Fed's own zero percent interest rate policy. If you can lower overnight rates to the point that money is free and communicate that rates will be there for some time, then companies will borrow and use those resources to hire and expand operations. This is supposed to jumpstart a recovery and lead to a virtuous cycle of economic activity that will replicate or make up for output that was lost during the recession, and eventually allow policy to return to normal. Boosting corporate debt levels isn't a symptom, it's the prescribed antidote.

Ironically, Yellen's warnings also echo the critiques of the Fed's biggest ideological opponents, the Austrian school economists. From an Austrian perspective, driving interest rates to an artificially low level leads to a mismatch in the coordination of resources over time. Companies that otherwise wouldn't see future demand for their products interpret low rates as a green light to expand even though consumers don't want more of what they're producing. This leads to widespread "malinvestment" throughout the economy as less efficient and innovative firms take on debt they won't be able to service in the future. Finally, as central bank interventions run their course - and rates rise once again - those companies that misinterpreted the signals go belly up. It sure seems that sounding an alarm over rising interest rates and a debt hangover fits this Austrian framework, but we never in a million years expected to hear it from Yellen.

For the record, we don't fully agree with either one of these perspectives. The Keynesians still venerate the Fed's low rates and QE (which supposedly boosted demand) as the source of the recovery while we believe innovation and entrepreneurship led the way. When 2008 happened, smartphones weren't ubiquitous, the human genome wasn't cracked, the US wasn't the world's largest energy producer, and we could go on and on. Meanwhile, some Austrians believe the recovery was all a sugar high and refuse to acknowledge that profits have consistently risen year after year as technology lowered production costs, boosted profit margins and lifted productivity in the private sector. Don't get us wrong, the idea of unelected bureaucrats centrally planning the price of money in Washington is pure hubris and we'd love to see the Fed's power reined in, but the recovery hasn't just been monetary smoke and mirrors.

So where does that leave us with the question of corporate debt? Yes, nonfinancial corporate debt is at a record high but so are nonfinancial corporate assets. Since 1980, nonfinancial corporate debt has averaged 44.9% of total assets (financial assets, real estate, equipment, inventories, and intellectual property). Right now, these debts total 44.7% of assets, or slightly less than average. The record was 50.4 in 1993. Notably, 1993 was right at the beginning of the longest economic expansion in US history. Further, both nonfinancial corporate cash holdings and profits are at a record high, and interest payments as a percentage of profits are currently at or below their long-term average. Finally, delinquency rates for commercial and industrial loans are near record lows.

All these data point toward corporate balance sheets being remarkably healthy, and while it's inevitable that a deterioration will happen, this is currently not something investors need to concern themselves with. Further, a real (inflation-adjusted) fed funds rate that has just now ticked positive for the first time in a decade is far from contractionary, especially with nominal GDP growth accelerating to an annualized pace of 4.8% over the past two years and $1.6 trillion in excess reserves still floating around in the banking system. This is just another case where data trumps rhetoric, even if that rhetoric comes from a former Fed chair.