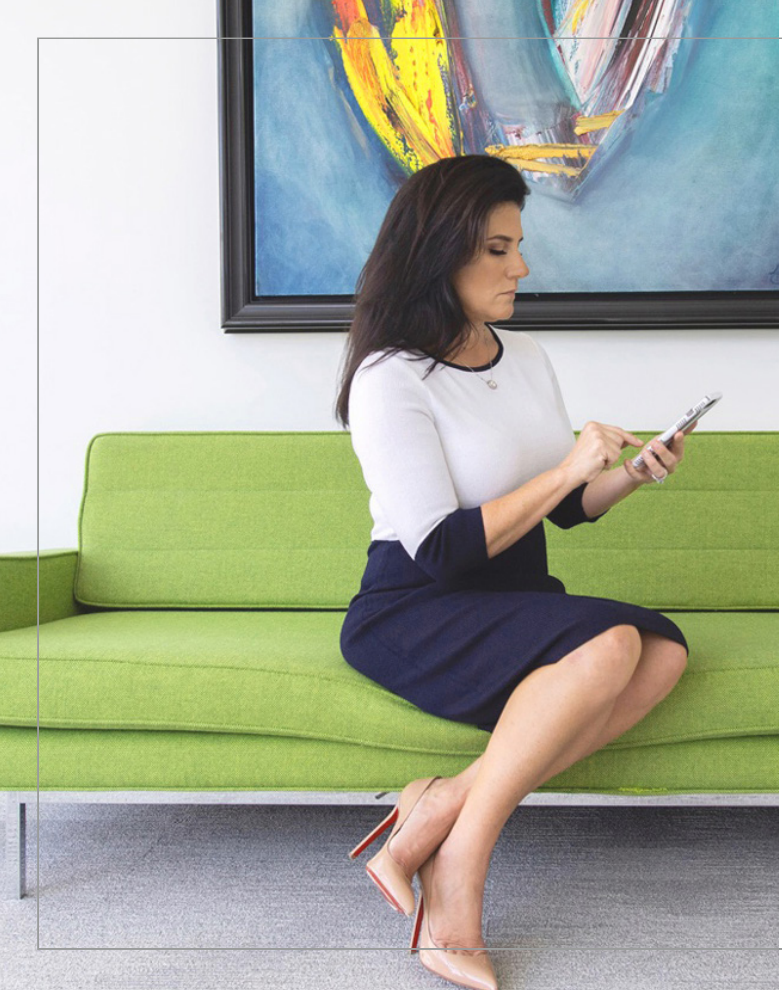
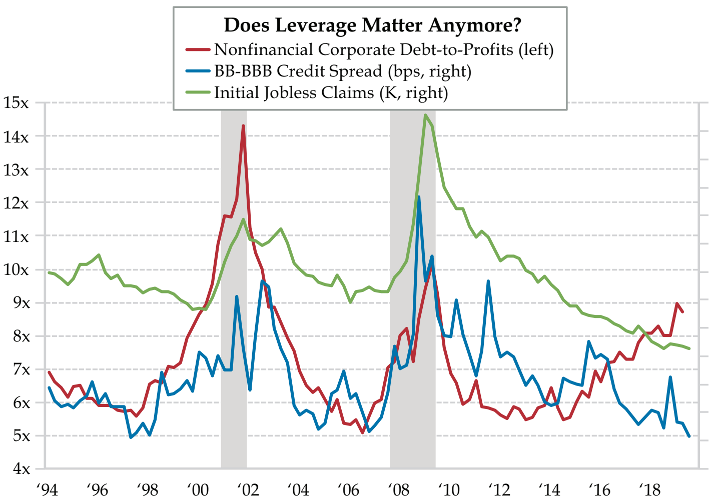


The Daily Feather

Noise Silencing Policy

VIPs

- Boston Fed President Eric Rosengren sees very low rates encouraging excessive leverage and risky asset overvaluation; S&P concurred with a recent study that cited add-backs for overestimating earnings and underestimating leverage in M&A and LBO transactions
- Compression in the BB-BBB credit spread is not occurring because of fundamental strength, but instead due to investor anxiety; this defensive stance defies the generational lows in jobless claims
- Nonfinancial leverage looks set to reach new cycle highs in the three months ending September; another quarter of S&P 500 earnings in the red against peak nonfinancial debt as a share of GDP will begin to matter



Source: BEA, Bloomberg, Federal Reserve, U.S. Department of Labor. Recessions shaded.

Sometimes you're lacking the right equipment. That was indeed the case for one Paul Lueg in 1933. The German doctor of philosophy and medicine was fortunate enough to secure a patent for what would one day become a wildly popular and profitable product. The good fortune that wasn't meant to be began with Lueg's appreciation of sinusoidal tones. He discovered that if you employed phase-advancing waves, you could cancel those pesky tones in ear drums and further, that if you inverted polarity around a loudspeaker, you could achieve blissful silence. With us? (Neither are we.) But the point is moot. Noise silencing technology may have been theoretically feasible in the 1930s but no proper equipment existed to detect, process and generate the required sound until the 1950s when the first generation was to finally come into being.

Eric Rosengren, President of the Boston Federal Reserve, has clearly never been gifted a set of headphones that snuff out all sound. Unlike many of his peers on the Federal Open Market Committee, Rosengren sees downside to rate suppression. Consider this well-circulated gem from remarks he made last week: "One potential cost of increased accommodation is that very low rates can encourage households and firms to take excessive risks. This could show up in the form of increased household and firm leverage, with prices for risky assets reaching levels that may not be sustainable over time."

With all due deference to required central banker circumspection, we regret to inform Rosengren that the word "potential" falls ridiculously short. The "excessive risks" horse has long since left the barn.

Consider this fresh research from S&P Ratings Direct that dissected data from a large sample of merger and acquisition (M&A) and leveraged buyout (LBO) deals between 2015 and 2018. The study examined the effect of "add-backs," expenses that are added back to profits when a deal is being marketed to flatter profits.

Some add-backs are perfectly legitimate. Post deal-closure, for example, previous owners won't be paid the same fat salaries and bonuses they once were by new management. Severance costs won't factor in nor will personal expenses that may have been run through the company in its former life – think country club fees and posh positions for family members.

But it appears add-backs ("synergies" on steroids) have gone too far in this era of repressed rates, so much so that Tim Gramatovich, CIO of Gateway Credit Partners recently told Reuters, "Unjustified add-backs will be the biggest issue in this cycle." S&P would agree. Of the deals examined, they found add-backs inflated EBITDA by an average of 28% and represented 49% of reported EBITDA at deal inception.

The upshot of this aggression: "actual reported net leverage was 3.1 turns higher than forecast for 2017 and 3.3 turns higher than forecast for 2018. Overestimated earnings were the primary contributor to the leverage disparity, **with reported EBITDA 35% below marketing EBITDA for both 2017 and 2018.**"

This bottom-line assessment corroborates Rosengren's concern that risky asset prices "already seem inflated" and "have the potential to amplify a downturn, should it occur."

As to his repeating the word "potential," we offer up today's Exhibit. As you know, the corporate credit spectrum begins with the pristine, and almost extinct, 'AAA' and ends at 'CCC,' as in one notch above 'D' for default. At the intersection of investment grade (IG) and high yield (HY), you find 'BBB' nudged up against 'BB.' Crossing the line down to 'BB' constitutes a "downgrade to junk" (Google Ford).

Of late, investors have clamored for the least risky ratings in both IG and HY. The mathematical result is a compression of the BB-BBB spread between the least junky of HY and riskiest-rated issues in IG, the blue line above.

When cycles end, this spread blows out as downgraded firms are forced to reduce headcount. That's where we are today. The multi-decade low in spreads we're witnessing reflects anxiety among investors, not calm in the market. And investors' defensive stance defies the generational low levels in jobless claims.

It's more likely that red line – nonfinancial corporate debt/profits – is poised to rise. Earnings season is nearly upon us and looks to mark the third consecutive quarter in the red for the S&P 500. Nonfinancial debt as a percentage of GDP at a record high 74% will begin to matter as profits continue to decline.

As for those "excessive risks" encouraged by Fed policy – historically record-high leverage in M&A and LBOs comes to mind – S&P notes that promises to de-lever post-deal ring hollow: "About two-thirds of companies kept debt levels in check (exceeded or within 10% of their targets) in the first year. That share quickly deteriorated to 48% by the end of the second year." Like most on the Fed, investors would be well served removing their noise-cancelling headphones.

