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FALLING CASHFLOWS: *The Catalyst for a Turning Credit Cycle*

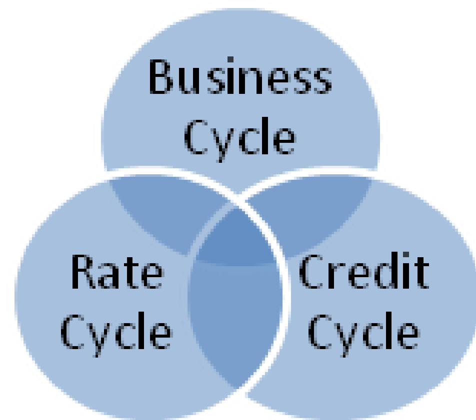
MACRO INSIGHTS

Gordon T Long
11/22/2015

FALLING CASHFLOWS

The Catalyst for a Turning Credit Cycle

CREDIT CYCLE REVERSING



We have been outlining for some time that top line corporate revenue growth has been falling and illustrated at the end of Q2 2015 we had incurred two consecutive quarters of negative growth. Unless corporate expense rates are immediately cut, operating margins are impacted and cash flows are reduced. Since market valuations are theoretically based on future discounted free cash flows we normally expect to begin to see weakening equity markets.

However, the reality of all of this has been obscured since massive corporate lending has been used to buy back shares at unprecedented levels making earnings per share (eps) and dividend payouts on the surface look attractive. The question is how long can this delusional charade go on?

The short answer is until reduced cash flows and debt levels threaten credit downgrades and the credit cycle reverses.

We have now reached that point!

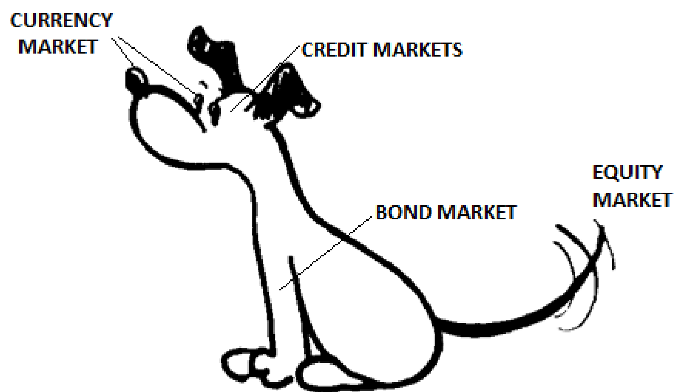
THE CASH FLOW CATALYST

It has been my experience that credit markets normally lead cyclical changes. Slowing cash flows are the first indicators. Often they are associated with anomalies in currency markets which additionally impact profits and potential cash flows.

Globally, seriously slowing global trade volumes and a strong US dollar have been major headwinds to corporate profits. These headwinds have intensifying and are rapidly reversing the credit cycle as debt burdens quickly become potentially unmanageable. This is blatantly evident in the commodity complex and the energy sector.

The Fed reported in its quarterly Senior Loan Officer Opinion Survey of October that banks have begun to tighten lending standards on commercial and industrial loans – the first tightening after three years of loosening lending standards, and after tightening throughout the Financial Crisis. This is a major confirmation of reversing credit cycle.

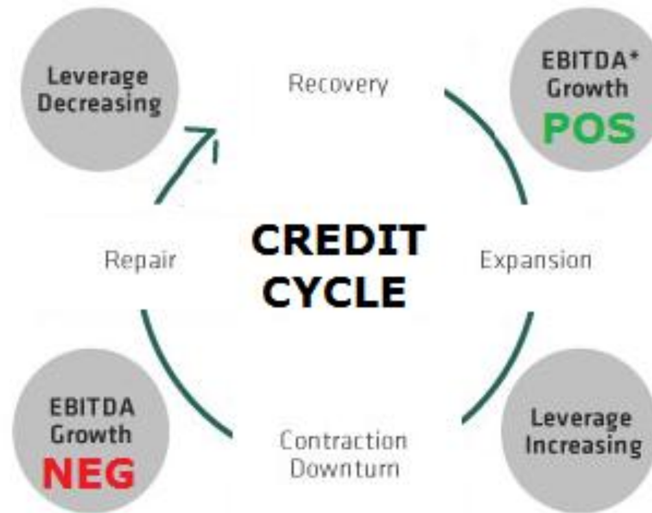
According to a report by John Lonski, Chief Economist at Moody's Capital Markets Research, we in fact have evidence that the cycle has reversed.



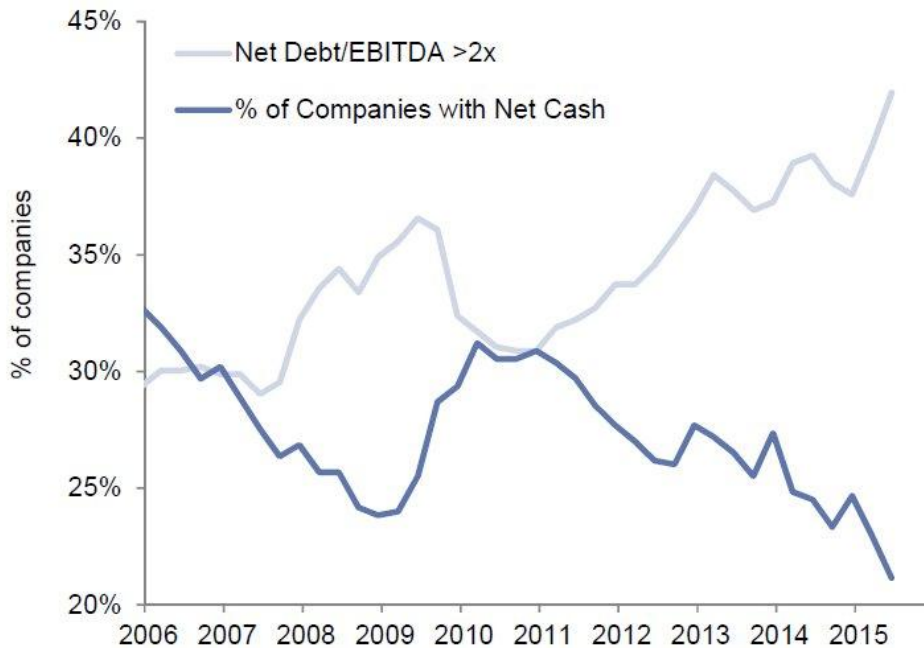
CURRENCY & CREDIT LEAD - BONDS & EQUITY FOLLOW

Alarmingly, is the fact that the last two times lending standards switched from loosening to tightening to such a similar degree, according to Lonski, was during the infamous Q3 2007 and Q4 1998 periods which most investors are acutely aware of.

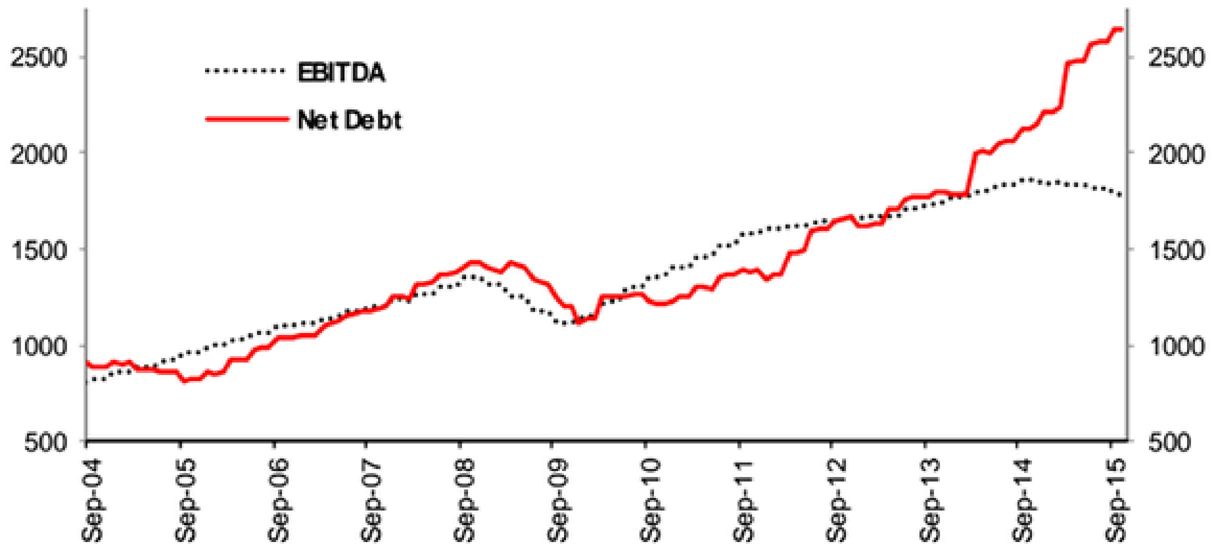
This time however, the pile of debt is far larger, and the risks – thanks to the Central Bank's sustained six year policies of ZIRP and QE have made the problem much, much larger and more intractable.



Net EBITDA 2x Highest since 2006 % of companies with net cash Lowest since 2006



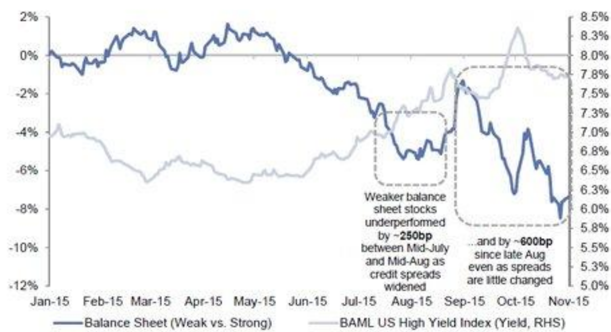
US corporate net debt has exploded and massively exceeds EBITDA ($bn, S&P 1500 ex fins)



Source: SG Cross Asset Research/Equity Quant

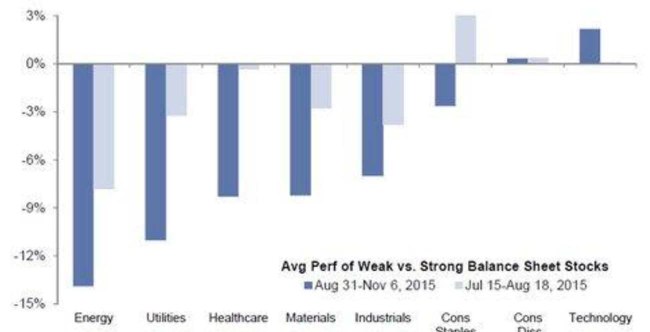
Companies with weak balance sheets have come under pressure as the markets are becoming increasingly concerned about credit risk.

Exhibit 19: Weak Balance Sheet stocks have come under pressure recently...
Balance Sheet factor (Weakest vs. Strongest 20%) YTD Perf; BAML HY Index Yield



Source: FactSet, Goldman Sachs Global Investment Research.

Exhibit 20: ... which extends across most sectors
Average performance of weak vs. strong balance sheet stocks



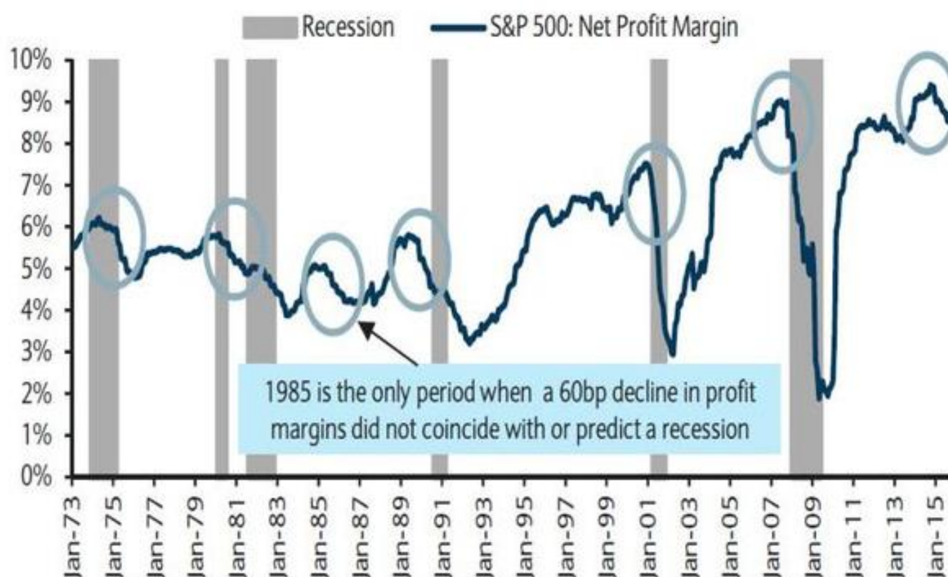
Source: FactSet, Goldman Sachs Global Investment Research.

In Exhibits 21 and 22, we identify companies with weak balance sheets, broken down between Energy and the broader market. We specifically look for names with (1) **High Net Debt / EBITDA**, as measured by those above 4x in 2016E and where it is likely to remain above 3x on 2017 estimates, and (2) **Low Interest Coverage**, including those below 2.5x in 2016E (below 1x for Energy) and below 3.0x in 2017.

PROFIT MARGINS NOW DECLINING

Jeff Gundlach at Doubleline shows further margin pressures are still ahead.

S&P 500 Net Profit Margin



Source: Thomson Reuters, Barclays Research

Source: S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. You cannot invest directly in an index.

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CREDIT UPGRADE RATIO

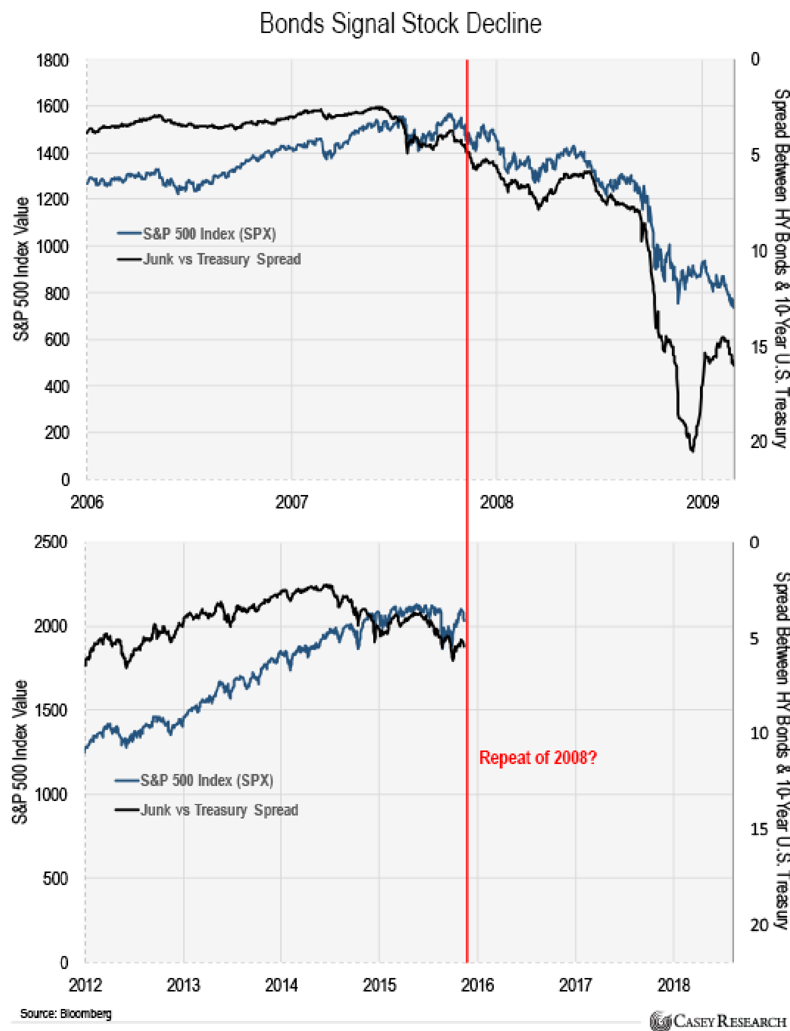
Wolf Richter reports:

> One metric that marks turning points in the credit cycle is the credit upgrade ratio. In Q2 this year, the ratio of ratings upgrades to total ratings revisions for junk bonds was still 49%. By Q3, this upgrade ratio had fallen to 39%, the worst level since Q2 2009 when it was 30%. Halfway into Q4, there have been 18 upgrades and 57 downgrades, a ratio of 24%, the worst since Q1 2009.
>
> Among investment-grade bonds, the ratio is even more terrible: 1 upgrade and 11 downgrades. "A convincing negative trend may be emerging," the report said gingerly.
>
> To reduce quarter-to-quarter volatility in the metric, Lonski looks at the upgrade-ratio of two quarters combined. In Q3 and Q4 so far, the combined upgrade ratio is 35%, a hair better than the 34% from the two quarters ended September 2009. The ratio had bottomed out in the two quarters ended March 2009 at 13%.
>
> But here's the thing: the last two times when the upgrade ratio fell from above 40% to below 40% was in Q4 2007 (at 37%) as exploding debt was already putting cracks into the financial system, and in Q4 1998 (at 29%) as the dotcom bubble was approaching its final year.
>
> "Both episodes constituted important turning points in the corporate credit cycle. Thereafter, not only did high-yield bond spreads remain relatively wide, but both projected and actual default rates trended higher," the report pointed out – a hilarious understatement, given the fiascos that followed.
>
> And these "projected and actual default rates" are already taking off. The Expected Default Frequency (EDF) of US and Canadian junk-rated companies, a metric of future defaults, hit 5.6%, the highest since the 6.4% of August 2009.

BOND MARKET

Casey Research's E.B. Tucker shares an urgent warning you're unlikely to hear anywhere else about what is happening in the bond market regarding the spread of interest rate yields between high-quality bonds & lower quality bonds (also called junk bonds). During good times, this spread is low. Risky investments only pay 2-3% more than U.S. Treasuries. As long as good times persist, that's enough compensation for greater risk. During bad times, the spread expands to 5%...10%...even more than 15% occasionally. The spread indicator flashed a major warning sign back just before the financial crisis. "But recent price action in the junk bond market says the party is over… and it's time to get cautious.

If you look back at the chart below, you see the junk bond market sent the exact same telling signal in December of 2014. Just like in the months leading up to the financial crisis crash, nobody seems to notice. The junk bond market is making it clear trouble is right around the corner. It is signaling that we could be in for another economic downturn, or worse, a crash. Meanwhile, stocks are still near their highs."



HIGH YEILD MARKET

Business Insider highlights how the junk-bond market is now signaling stress in that area of lending. Again, Jeff Gundlach observes that credit-rating downgrades were outpacing credit-rating upgrades. He notes that, in the past, a tick below the blue line was "the beginning of something big". He suggests this is a reason for caution in the financial markets. The financial markets are factoring in that the Federal Reserve will begin

tightening monetary policy with an interest-rate hike in December - the risk is that the Federal Reserve ignites turmoil in the markets & is forced to loosen again.

High Yield Last 12-Months Upgrade-to-Downgrade Ratio

December 31, 1995 through October 15, 2015

Source: JP Morgan
LTM = Last twelve months. You cannot invest directly in an index.

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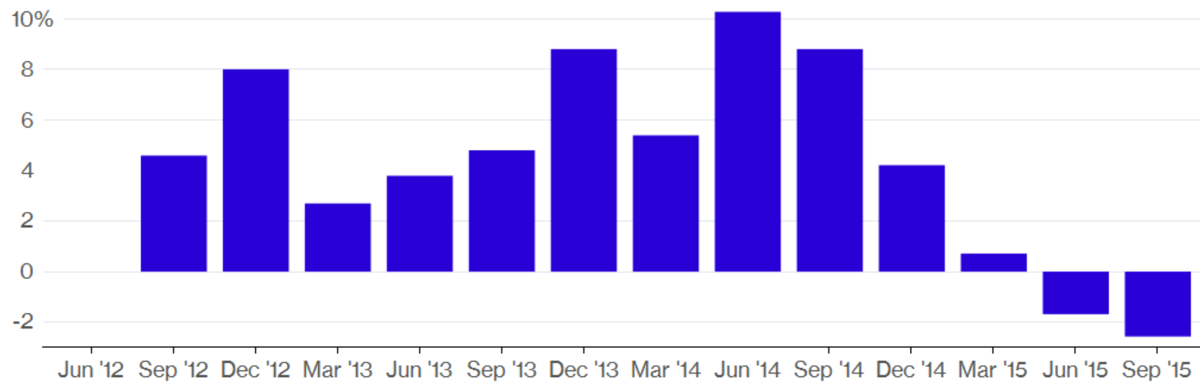
EARNINGS PROBLEMS AHEAD

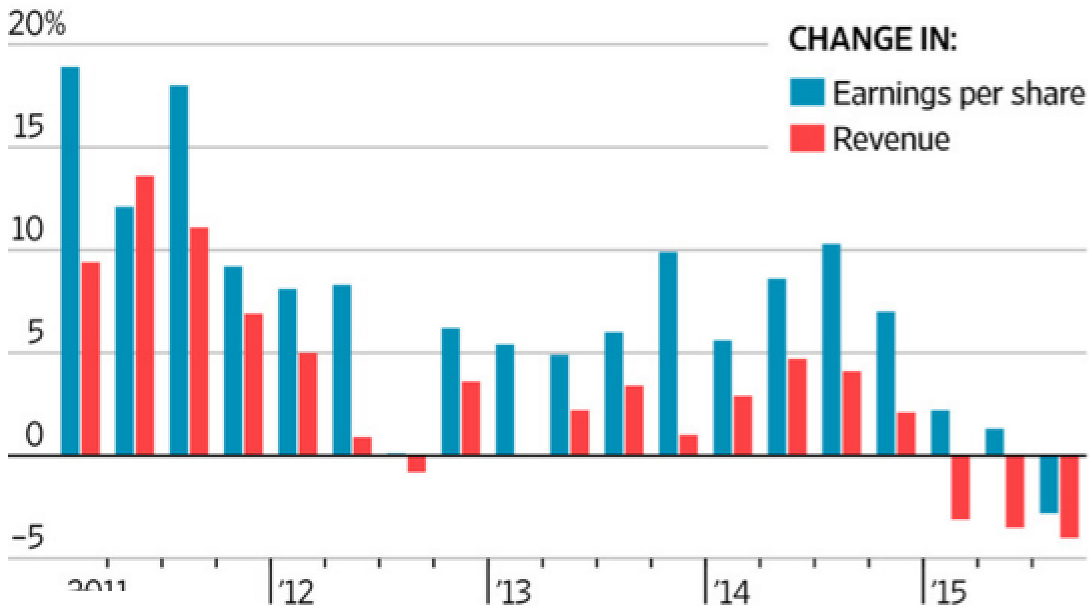
U.S. Earnings Losing Steam

3Q Season Set to Post Biggest Drop in Profits Since 2009

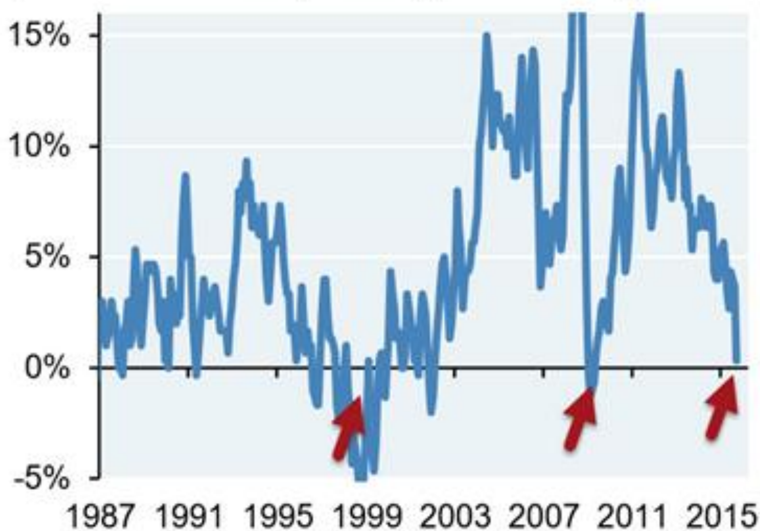


U.S. quarterly EPS growth y/y; data compiled by Bloomberg

Bloomberg

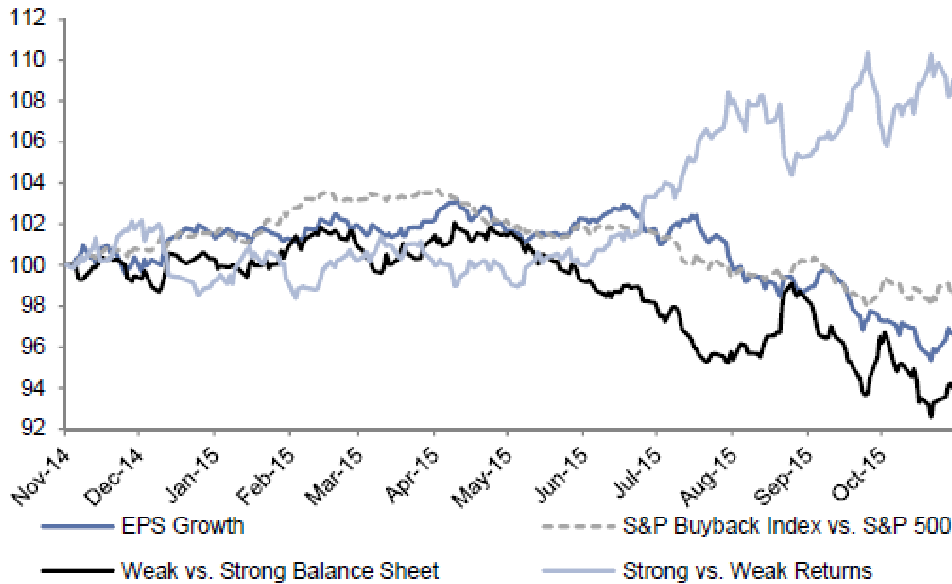


SMALL BUSINESS SENTIMENT & CONFIDENCE DOESN'T BODE WELL!



MARKET STARTING TO REWARD RETURNS

Exhibit 26: As the market has grown more cautious around leverage, EPS growth and buybacks it has started to reward strong returns
EPS growth, balance sheet and returns are market-neutral (top 20% vs. bottom 20%)



Source: Goldman Sachs Global Investment Research.

This is soon going to get very ugly. Don't say you weren't warned!

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