Article

Financial markets

The health of the US corporate sector, a crucial factor for financial stability

Content available in
Spanish Catalan

Last April the International Monetary Fund (IMF) published its latest Global Financial Stability Report. The report reviews the trends in the financial markets and the key threats to financial stability. In it, the IMF states that financial stability has improved owing largely to a reduction in macroeconomic risks resulting from the positive economic activity and confidence indicators which have been released over the past few months. But it also points out that the risks are still high. The IMF emphasizes the elevated political uncertainty for the advanced economies. For the emerging economies, the report stresses the potential impact of a tightening of global financial conditions as one of the main sources of risk.

The IMF has also underlined the increasing vulnerability of the US corporate sector and the potential impact of some of the policies being considered by the Trump administration. Specifically, one of the measures mentioned in the report is the ambitious tax reform unveiled by President Trump during his electoral campaign, a first draft of which was presented at the end of April, notably the intention to cut the corporate tax from the current rate of 35% down to 15%. According to IMF estimates, all the fiscal policy measures planned by the Trump administration could considerably increase corporate earnings, providing a boost for capital expenditure.

But the IMF has also pointed out that the financial situation of the US corporate sector has deteriorated significantly over the past few years. This has been reflected in poorer asset quality, a rising share of rating downgrades in a number of industries and the elevated levels of leverage among S&P 500 firms, now close to a historic high. According to the IMF, all this points to a change in the US corporate earnings cycle, which might be heading for a slowdown. Such a slowdown, if it comes about, would occur in a context of increasing leverage and a higher level of debt servicing as a proportion of income which, in spite of low interest rates, is at its highest level since 2010.

Given this delicate environment, Trump's expansionary policies could actually have some unwelcome effects on the corporate sector. As the US economy is very close to full employment, a fiscal stimulus such as the one planned is likely to boost growth less than expected but might increase inflationary pressures. This, in turn, would force the Fed to raise the fed funds rate more quickly than expected, pushing up the cost of debt and thereby putting a significant number of companies under pressure. The IMF estimates that around 20% of US firms currently have a low debt service capacity,[1] making them vulnerable to a sharper-than-expected tightening of financial conditions. This could lead to a substantial rise in corporate risk premiums. Nevertheless, it should be noted that a large number of the companies threatened by this situation come from just a few sectors, namely energy, real estate and utilities.

1. Debt service capacity is measured with the interest coverage ratio which is the ratio between earnings and interest expenses. Those companies with a ratio below two are in a

vulnerable situation.

Tags

Financial stability

United States of America