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A Global Slowdown Will Test US Corporate Fragility

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Our recent analysis of the trends impacting the financial balances of the private, government, and external sectors of the US economy found that the current recovery, which is already the weakest in US history (albeit also the longest), is likely to become even more anemic, with GDP growth projected to average 1.5 percent over the 2020–23 period. More alarming than this weakening baseline growth trend—particularly given rapidly growing uncertainty about the potential global fallout from an emerging pandemic—is that we find evidence that corporate sector balance sheets are significantly overstretched, exhibiting a degree of fragility that, according to some measures, is unmatched in the postwar historical record. In the context of an overvalued stock market, this is a situation in which even a mild shock could create harmful ripple effects with serious impacts on economic activity.

In the last few quarters for which we have data, US GDP growth has been driven entirely by consumption and, to a much lesser extent, government expenditure. The latter is a notable development: until the omnibus bill that was passed in 2018 took effect, this had been the only postwar economic recovery in which government spending shrank. It was only in 2019 that real government expenditure reached a higher level than it registered when the recovery began (2009Q2). At least part of the reason we projected baseline GDP growth to decelerate going forward is that government expenditure will be less supportive as the provisions of the 2018 omnibus bill expire (it remains to be seen whether the emerging public health crisis and global turmoil will push Congress and this administration to agree on an extensive fiscal stimulus package). By contrast with the positive contributions of consumption and public spending, private investment declined on an annual basis over the first three quarters of 2019, and, despite the administration's vocal emphasis on trade policy, net exports were likewise a drag on GDP growth (imports were stable while exports decreased). Looking ahead, there is little reason to expect these investment and net export trends to reverse themselves—and significant danger of a greater downside risk in the external sector.

The administration's erratic trade policy has not been a success story, but even if trade tensions do not escalate further (in a presidential election year, we expect more caution from the administration on this front), there are more significant headwinds from the foreign sector: namely, the appreciation of the US dollar, which is at its highest level in the post–Bretton Woods era, and declining real GDP growth among US trading partners. While the International Monetary Fund (IMF) projects the growth rates of these trading partners will bounce back to what is assumed to be their "natural" rates (an assumption embedded in the IMF's model), it is difficult to tell a story about what forces would drive this outcome. If trading partner growth rates do not pick up or, worse, they deteriorate further—which was an entirely plausible scenario even before the prospect of significant disruptions due to the coronavirus—this would drag US net exports, and thus GDP growth, below our baseline projections.

To make matters worse, this would be occurring against a background in which the US economy has become ever more fragile. This instability is exhibited by two simultaneous Minskyan processes: an overvaluation in asset markets and a weakening of corporate balance sheets. By some measures, the stock market's valuation has reached levels comparable to those seen in 1929 and the late 1990s, with the potential for a similarly dramatic correction. Meanwhile, the nonfinancial corporate sector's liabilities are now higher as a percentage of GDP than they were in 2007, on the cusp of the crisis, and the corporate sector's gross leverage is higher than both its pre-2008 crisis and late 1990s levels. The share of issuers of corporate debt issuing the lowest investment-grade rated bonds (BBB) has increased, and the share of BBB-rated bonds in investment-grade corporate bond mutual fund portfolios has grown from 18 percent in 2010 to 45 percent today (while the share of A-rated bonds has declined). Moreover, the number of firms in a "Ponzi" position—Hyman Minsky's infamous terminology for firms whose cash flows cannot cover the interest payments on their debt—has increased (despite very low interest rates), as has the share of "zombie" firms, a similar concept.

With this combination of overvalued asset markets and overleveraged corporate balance sheets, the US economy is vulnerable to a shock that could trigger a cascade of falling asset prices and private sector deleveraging, with severe consequences for both the real and financial sides of the economy. It is not clear what will end up being the ultimate tipping point—whether a deceleration of the global economy, perhaps worsened by this incipient global health crisis, or some other, as yet unanticipated, series of events. What is becoming clear, however, is that the US economy is sitting on a fault line.

A more detailed discussion of the issues can be found at levyinstitute.org/publications/prospects-and-challenges-for-the-us-economy-2020-and-beyond.

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