TEMPLETON & PHILLIPS
CAPITAL MANAGEMENT, LLC
A BETTER VALUE

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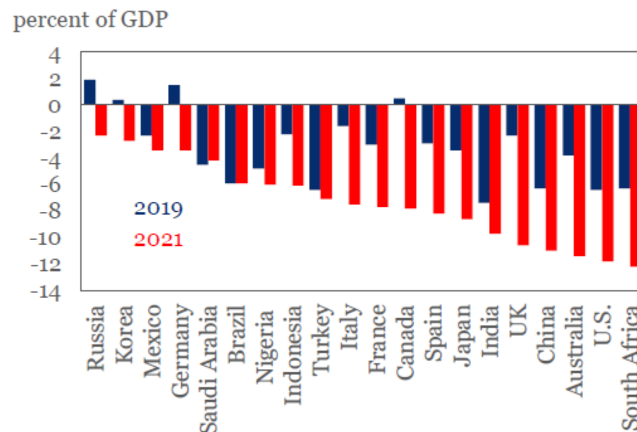
SELF-RELIANCE

If you perform a Google search on the phrase “world’s biggest economic risks” you will find a familiar list of global concerns including climate change, infectious disease, and income inequality. However, if you search a little further, you may eventually locate the term “debt crisis.” As you reflect on the list you will need to disregard that policymaker responses to the former risks correlate with the odds of the latter.

Since we last discussed the startling deficit spending and subsequent debt increases of 2020 (in our 3Q20 commentary The Debt), these policies have only seemed to gather steam. Also, in the time since it has become clear that fiscal prudence is of little concern among policy makers and most of the electorate too.

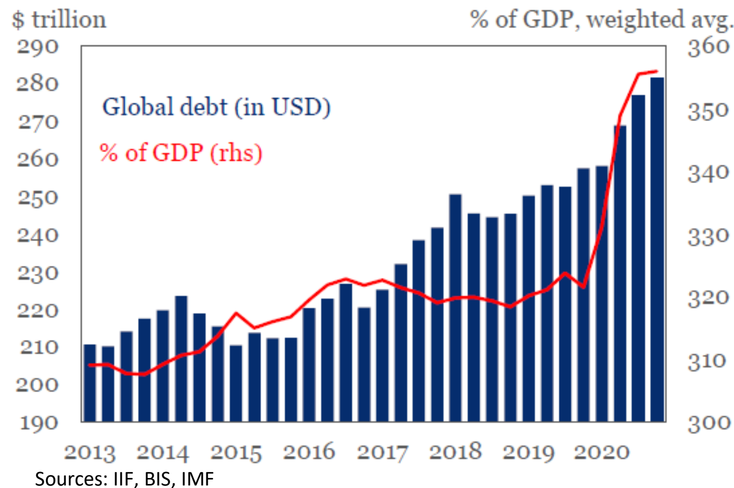
Chart 4: Surge in fiscal deficits worldwide



Sources: IMF, IIF

As a result, the IMF is now projecting global public debt as a percentage of GDP to reach 130% within the next year; eclipsing World War II levels. While government debt increases have certainly led the way, corporate debt has been another noticeable contributor. Taken as a whole (government, households, corporates, and financial sector) debt has reached a global record $281.5 trillion by the end of 2020, representing over 355% of GDP.

Chart 1: Global debt hits a fresh record high in 2020



Sources: IIF, BIS, IMF

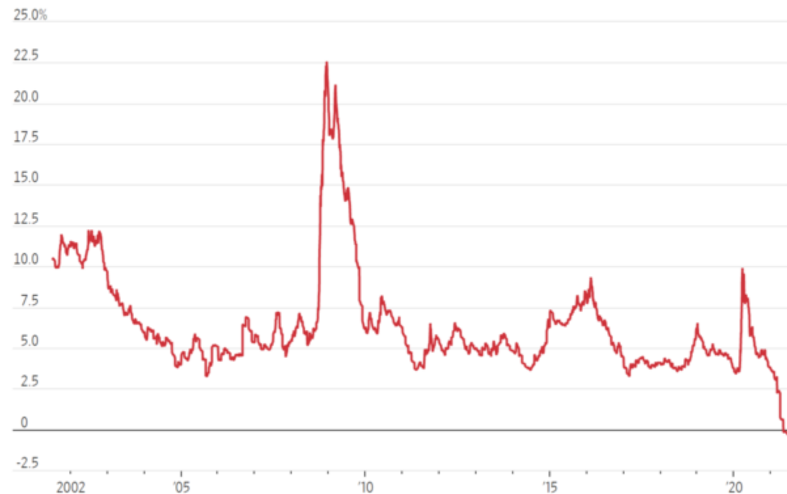
The large spike in public debt is a troubling outcome of the pandemic that eventually needs to be reconciled. Most observers would agree but seem to find comfort in the word "eventually." Nevertheless, this complacency is supported by the low interest rates enabling this behavior among spend-thrift governments (mostly developed markets), their large deficits and the accompanying growth in debt. While it is possible that macroeconomists and voters alike have the luxury of complacency, the downstream effects of these policies merit closer attention among investors. One area that we believe deserves investor attention is the accompanying growth in corporate debt, which was already high in 2019 and headed much higher throughout 2020. Let us take a closer look.

In the fourth quarter of 2019, corporate debt as a percentage of GDP stood at a record 46.5% and the average investment grade corporate bond yielded 2.84%.[1] As the COVID-panic and lockdowns set in it was crystal clear that indebted corporate borrowers were vulnerable to a seismic wave of defaults. However, as the Federal Reserve introduced emergency facilities (e.g., SMCCF) for corporate issuers—in addition to its conventional QE efforts—it slammed market forces into reverse. The effort led to some previously unimaginable outcomes. First, corporate issuance hit a record $1.7 trillion for the year, and by the end of 2020, the average yield on investment grade corporate debt had fallen to 1.74%, an all-time low. All of this unfolded during the worst economic recession since the 1930s.

As it stands today, high yield bonds carry the riskiest coverage ratios since the mid-1980s, with debt to EBITDA at 6.5x. Meanwhile, junk bond yields minus inflation recently touched record lows in mid-June of this year (illustration below). Expressed in terms of spread versus Treasuries, junk bonds reached a low of 312 basis points over the 5 Year Treasury—a low not seen since 2007. The mixture of weak coverage ratios and investor enthusiasm for junk bonds resemble a pile of kindling in search of a match.

[1] Pandemic Hangover: $11 Trillion in Corporate Debt. WSJ June 14, 2021

Junk Bond Yields Minus CPI



Source: WSJ, Bespoke Investment Group

To be sure, matches seem scarce for the moment. The narrow junk spreads (above) and other signs of investor enthusiasm may have found safe harbor in the current recovery environment. There is no doubt that corporate profits have recovered from 2020. GDP too has crested its pre-pandemic high. Finally, the corporate debt raised in 2020 represents today a potential cash buffer for the most indebted firms to delay any reckoning. In our opinion, investor consensus seems to hold that the new business (profit) cycle implies that high corporate debt levels only represent a future problem; the cycle will develop, mature, enter recession, and only then credit defaults emerge. Bringing it full circle, the investor attitude resembles that among policy makers and voters: the debt is high, but it is a future problem.

While acknowledging the arguments above, we are less complacent. Our opinion is that the consensus is applying a conventional view of the business cycle, but this cycle appears anything but conventional. More specifically, the COVID-related recession was government-imposed and according to the NBER only lasted two-months (Feb. 2020 – Apr. 2020). However, one of the important features of a conventional recession is its role in correcting the previous cycle's excesses (e.g., excessive debt, risk-taking, bankruptcies, etc.). We believe these market forces were not only halted but materially reversed by the Federal Reserve. In sum, despite its strange, noisy elements the current cycle appears to be primarily an extension of the old one—featuring too much corporate debt.

Despite the risk backdrop, it is important to remember that "trouble is opportunity." In the context of our discussion, we see persistent market share gaining opportunities for our portfolio companies in an environment of over-leveraged and/or cash strapped competitors. This perspective has driven our stock selection preferences for the past several years and was emphasized again during our purchases in March of 2020. With that said, we believe we our portfolio is well prepared for a deteriorating credit environment marked by rising defaults. In short, we believe our companies will take market share and/or invest further in their businesses in such an environment.

Our portfolio companies received a relatively good test of their ability to take market share during the global COVID-lockdowns of 2020, and for all intents and purposes we have been pleased with the results as these gains are now showing up in year-over-year earnings comparisons.

We believe one good example can be found in our holding of Mondelez International. Mondelez International is a global snack and beverage producer, with market leading brands including Oreo, Ritz, Chips Ahoy, Cadbury, and more. The company sells its products around the world, including a strong presence in the faster growing emerging economies. Most importantly however, its persistent growth strategy did not slow down in 2020 and led to key market share gains based on product innovation and strategic acquisitions in faster growing categories, such as health snacks. In turn, these strategies led to market share gains during 2020 in key markets such as the U.S., China, U.K., Australia, and Russian. We believe these market share gains helped propel the company's 2021 earnings surprises, dividend increase, and share repurchases. The key point here though is not congratulatory, but instead to emphasize that the process or "growth algorithm" that Mondelez employed was well-executed and is repeatable, in our opinion. Our opinion partly rests upon the company's self-imposed mandate of an investment grade corporate debt rating. This helps reassure us that it can remain well-positioned to execute on its growth algorithm in an economic environment defined by a credit downturn, rising defaults, bankruptcies, recession, etc. The bottom-line is that Mondelez deploys a growth strategy that is both self-reliant and sustainable. We believe these fundamentals stand in contrast to a growing number of firms who may one day find themselves reliant on the kindness of strangers.

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Disclosures

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