Too Much Debt is Dangerous for the Stock Market

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Previous Market Excesses

A form of what you might call funny money is typically what drives the markets to excessively high levels.

In 1998-99, any internet related stock was driven to crazy levels, regardless of whether the company even had a viable future. Investors didn't want to miss out on the returns their neighbors were getting and internet stocks and their valuations became so far unhinged from reality that they were like funny money.

Excess internet stock valuations drove the PE ratio on the S&P 500 to 27 times earnings, well above the norm of about 16 times. As it became apparent that the valuations for internet-related stocks didn't jibe with **reality,** the market had a very difficult time in 2000-02. Investors in the old economy stocks fared better as they had avoided the overvalued portion of the market.

In 2006-07 funny money in the form of wildly optimistic mortgage underwriting allowed almost anyone to qualify for a mortgage. In true value, based on a sober view of whether you would be paid back, mortgages were worth nowhere close to 100 cents on the dollar. Overly easy mortgage credit led to unsustainably high home prices and consumer confidence.

This optimism fed into **excessive** stock market valuations in 2006-07, although not at the levels of 1998-99. As mortgage defaults inevitably soared and the banking system and capital markets nearly froze, the market and the economy had a very difficult time in 2008, causing general pain for investors. But it was much worse for the companies that held the bad mortgages.

Current Excesses

To counteract the contractionary effects of the credit crisis, the world's central banks flooded their economies with money. **Ironically, this has led to the current form of funny money, artificially low borrowing costs for almost 10 years**. This has led to very high levels of debt outstanding, particularly low-quality debt, which has been scooped by investors looking for yield in a very low-rate environment.

Total leveraged debt outstanding (high-yield debt and leveraged loans) is now $2.5 trillion double what it was in 2007. With interest rates still at low levels, the fed funds rate at 2.0 to 2.25 percent is almost negative adjusted for inflation, and the pain for borrowers is yet to come.

In addition, the quality of debt outstanding has deteriorated but the lower standards are currently hidden by the level of interest rates. According to Standard and Poors global market intelligence, the average debt to operating cash flow on large corporate loans is just above the previous high in 2007, the average multiple of debt to cash flow on highly leveraged loans is just below 2007 levels, and middle market loans are well above their multiples in 2007.

Furthermore, on leveraged buyout loans, which are the most likely loans to default, 30 percent of deals structured in the past year incorporate "adjusted cash flows," not actual cash flows when determining maximum deal leverage.

This is up from up from seven percent of the deals structured in 2007 using similar adjustment allowances. Deal structures today also have less covenant protection against risky behavior by borrowers than they did in 2007.

Howard Marks puts it well by describing the capital markets as being like an auction. Although much of the lower-quality debt is now financed outside the banking system, artificially low interest rates and the search for yield has created many attendees to his hypothetical auction for **low-quality debt.** When many buyers show up to an auction the bidding will be heated, and the prices will be unrealistically high.

By buying trillions of dollars of high-quality bonds during their quantitative easing program, the fed created artificially low rates and purposefully drove investors out of low risk investments and to these auctions for low quality debt.

As rates normalize and go higher, that situation will likely reverse. Investors will be looking to put more money back into low-risk investments, creating significant problems for companies that need to refinance low-quality debt. It's likely not to be as severe as the previous downturns but as rates rise, the negative effect of the funny money will become more evident.

Don't Time The Markets But Try To Know Where The Risks Are

Attempting to time the markets has not turned out well for the average investor overtime. So, don't just sell because there are risks. Try to identify where the risks are.

Excess optimism or, in today's case, artificially low interest rates can end up being a dangerous thing while skepticism and risk aversion lead to safer valuations.

Warren Buffett probably put it best when he says, "the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs," which is what investors should do in the current environment.

Please feel free to contact us if you would like further information about our investment philosophy.

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