Debt Hangover Looms After US Borrowing Binge

July 30, 2018

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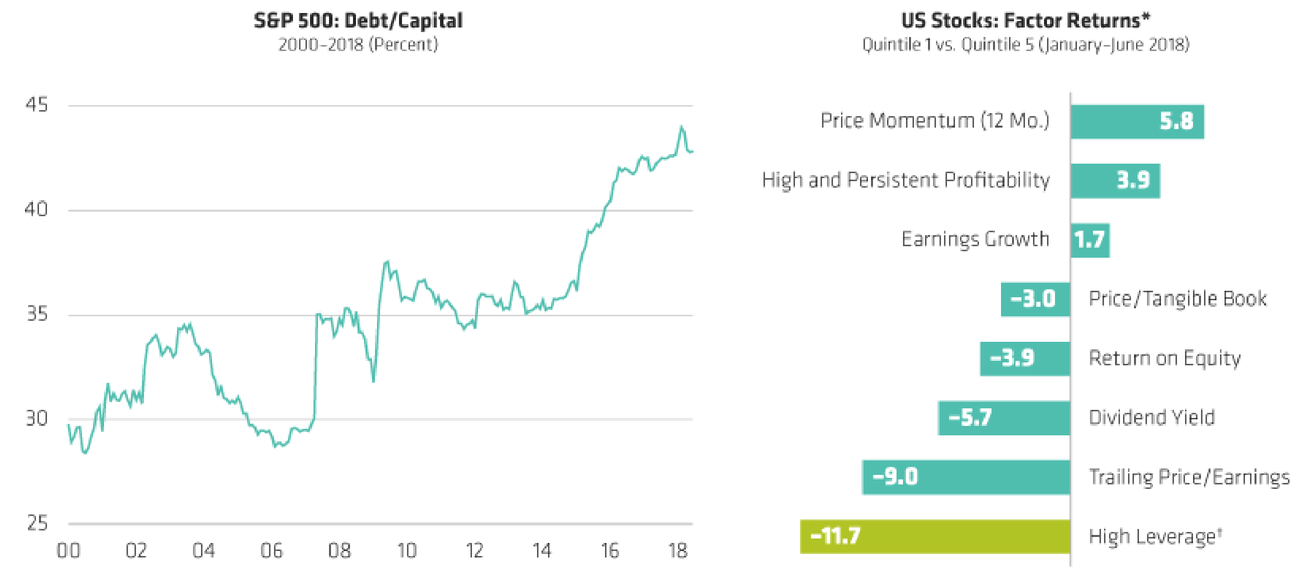
US Stocks with High Debt Look Vulnerable to Rising Rates



Through June 30, 2018

*Based on an equal-weighted universe of stocks in the AllianceBernstein US large-cap universe

†Based on net debt/equity. Excluding financial stocks

Source: Center for Research in Security Prices, IDC, Morningstar Direct, S&P, S&P Compustat, Thomson Reuters I/B/E/S and AllianceBernstein (AB)

US companies, lured by historically low interest rates, have taken on massive amounts of debt in recent years. As rates begin to rise, investors should beware of companies that might be vulnerable to increasing financing costs.

Over the last decade, US companies went on a borrowing binge. The debt/capital ratio of S&P 500 companies reached nearly 43% at the end of June (*Display, left*). Highly levered companies look vulnerable. Our research shows that shares of companies with the highest leverage sharply underperformed companies with the lowest debt burdens by 11.7% this year, while also lagging behind most other types of equity factors (*Display, right*).

It's time for investors to pay closer attention to debt, as the direction of rates is changing. Rising interest rates and financing costs threaten to erode profitability. And if inflation heats up, we expect the US Federal Reserve to raise rates faster than expected—which would make it even harder for companies to finance their debts.

There is a silver lining to this scenario. The easy-money era fueled broad gains in equity markets, which made it difficult for active managers to outperform the market. Now, as central banks gradually start to tighten, active managers who demonstrate real skill are likely to perform better. Focusing on debt will become more important, as companies with strong balance sheets are likely to have an edge over competitors saddled with heavier financial liabilities.

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