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The Changing Mix of Corporate Liquidity

by Jeffrey P. Avers

Standing at $5.4 trillion as of mid-2006, U.S. corporate cash is at an historic level. With year-over-year growth of $400 billion, or roughly 7.5 percent, it's continued on this same upward trajectory since the century began.

What has been driving this growth in cash? Unlike the cash build-up in the mid- and late 1990s, whose roots were seeded in the initial public offering (IPO) market, participants in Treasury Strategies' 2006 Corporate Liquidity Survey cited internally generated cash (cash flow from operations) as the number one driver of this unprecedented build-up. Indeed, as of mid-2006, the S&P 500 had seen a record 17 consecutive quarters of profit growth — and higher profits usually translate into more cash in corporate coffers.

Another driver in the cash build-up is the way corporate America has been hoarding cash rather than reinvesting in its core business, as it had done previously. Those that have increased their capital investments in recent years were more likely to have taken advantage of the historically low borrowing rates over the last few years.

From the perspective of the traditional statement of cash flows, the combination of an increase in cash flow from operations with flat or declining capital expenditures will likely increase year-over-year cash. While U.S. corporates are using some of this cash to pay down debt and effectively recapitalize the balance sheet, they are not using it to fund capital expenditures for financing internally generated growth at a rate that one might consider consistent with an economy that has produced 17 consecutive quarters of corporate profit growth.

Is this a precursor of an economic slowdown? Maybe, but we can't jump to this conclusion solely based on the build-up of balance sheet cash. It's logical that a period of unprecedented earnings growth would generate an unprecedented amount of cash, but if corporations are not aggressively reinvesting, that is of concern to economists and Wall Street analysts.

Other factors causing corporates to put expansion plans on hold might in-clude concerns over the Iraq war, fear of terrorist attacks, increased scrutiny from shareholders, regulators and Wall Street, as well as concerns about the implications of a Democrat-controlled Congress.

Also, this economy seems more interested in growth through acquisition than in internally-generated growth, as evidenced by the fact that $2.3 trillion in M&A deals were announced in 2006. With reports that 2007 could see M&A activity increase by 20 percent, a $3 trillion year for dealmakers is not out of the question. Maybe this cash build-up has been a precursor to this new wave of dealmaking and acquisition activity.

U.S. Cash Portfolios: Changing Mix

As of mid-2006, the Federal Reserve had raised the Fed funds target 17 consecutive times to a target of 5.25 percent, completing the interest rate cycle's "V" and returning the economy to the 5 percent rate environment experienced in 1999.

Throughout this cycle, the composition of corporate cash portfolios evolved along with the interest rate environment. As rates moved downward from 5 percent to 1 percent, corporate treasuries moved larger portions of their cash into instruments whose relative performance is negatively correlated with the direction of interest rate movements (e.g., money market funds outperform most other short-term investment instruments during a declining rate environment).

Conversely, from June 2004

through July 2006, as rates moved upward toward 5.25 percent, corporate treasuries shortened their portfolio maturities and increased their positions in instruments whose yield responds quickly to a Fed rate hike; repo, Eurodollar time deposits and other overnight to 30-day instruments meet this criteria.

Of particular interest was the 2005-6 year-over-year growth in money market funds' share of corporate cash wallet. With a growth rate of 29 percent (having grown from 21 percent in 2005 to 27 percent in 2006), this defies the logic of increasing one's position in instruments whose yield adjusts quickly in a rising rate environment… as money funds lag market rates in a rising rate environment.

Where Does Cash Go in 2007?

The view from corporate treasuries is more of the same. Nearly 75 percent of respondents to Treasury Strategies' survey indicated they expect their balance sheet cash position to be stable or to increase over the next 12 months. However, if the Fed achieves its objective of containing inflation by slowing down the economic expansion, that should mean flat or declining cash flow from operations, which would likely mean flat or decreased levels of balance sheet cash.

In a late November speech, Philadelphia Federal Reserve President Charles Plosser implied that the Fed is poised to fight any signs of inflation with additional rate hikes. Given that the Bernanke Fed appears to be committed to fighting the war against inflation, a contrarian view to those Wall Street pundits continuing to hawk a bull market indicates that in 2007, we will begin to see corporate balance sheet cash stabilize or shrink as we take a pause before the bull market continues.

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