Strategy*Insights*

Swanning around in Credit

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Executive Summary

There is growing concern about corporate credit globally. The volume of issuance has been very high over the last decade to the point where non-financial corporate debt as a proportion of GDP is now as high as it was in 2007 in the US and even higher still in the Eurozone. Furthermore, the proportion of investment grade debt rated BBB (one notch above high yield) is at or approaching record highs.

There has also been a record level of leveraged-loan issuance with a record percentage of cov-lite loans, now representing 80% of the loan market. The size of the leveraged loan market has ballooned to now equal the size of the high yield market in the US.

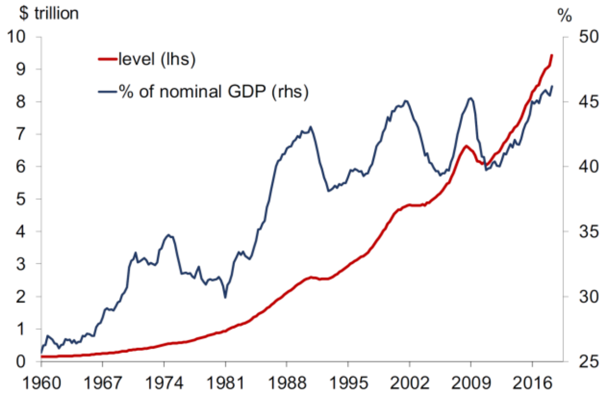
The risks of a global economic growth slowdown have risen at a time when the interest rate environment is dominated by policy makers with an upward bias. Slower economic growth will put pressure on corporate revenues and negatively impact interest coverage ratios.

Consequently, there is a risk of rating downgrades. Under normal circumstances this would of course be negative for risk sentiment anyway, but the scale of the potential problem is currently very high. A few rating downgrades from some of the larger BBB issuers has the potential to swamp the high yield market.

With bond market liquidity today is as bad as it has ever been, the risk highlighted is one where credit markets could seize up, potentially triggering a grey or black "swan" type event that would propagate negative risk sentiment across multiple asset classes. Despite credit spreads having risen in recent months, investors are not being properly rewarded for taking these risks.

US corporate debt: deteriorating credit quality

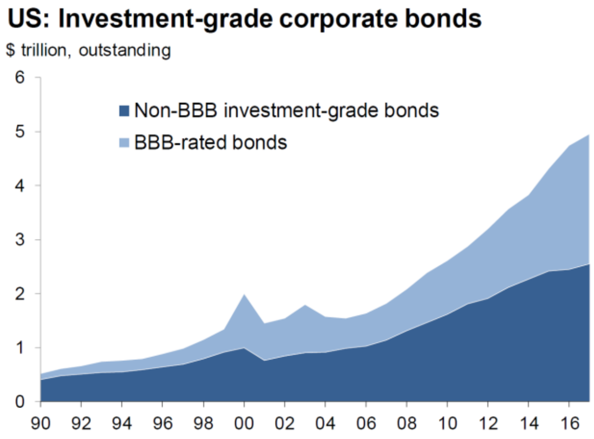
US: Nonfinancial corporate debt



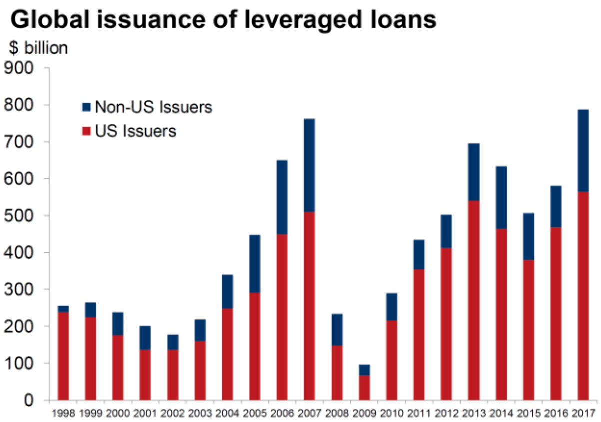
Source : Oxford Economics/Haver Analytics

With economic activity likely to slow in 2019, many observers see the so-called "corporate debt bubble" as a potential catalyst for the next downturn. The worries are justified to some extent, given the massive increase in corporate leverage since the Great Recession. The exceptional period of highly accommodative monetary policy, along with strong risk appetite, has encouraged rapid growth in US companies' debt over the past decade. The amount of non-financial corporate debt in the US has grown by an impressive 58% since its trough in 2010, reaching a record $9.6 trillion in Q3 2018 or 46% of nominal GDP (chart opposite). This compares with a cycle high of 45% during the previous economic expansion.

Credit quality has also deteriorated. The share of outstanding corporate bonds that are BBB-rated (the lower end of the investment-grade universe) has grown sharply in recent years (see left chart on the next page). As of 2017, roughly half of investment-grade corporate bonds outstanding were rated BBB, compared with 37% in 2007, amounting to about $2.5 trillion.



Source : Oxford Economics/WSJ



Source : Oxford Economics/IMF

Overall, BBB rated bonds now represent a sizeable 35% share of total corporate bonds outstanding. The issuance of US leveraged loans is also a concern, with issuance having more than doubled since 2010, reaching $564 billion in 2017 (chart above right). The level of leveraged loans outstanding has risen by about 12% over the past year alone, now standing at around $1 trillion.

Leveraged loans are typically made to highly levered firms with weak credit ratings and therefore carry a higher risk of default, especially as credit quality and underwriting standards have deteriorated in recent years. While default rates for leveraged loans have remained low, three factors are worrisome.

First, covenant-lite (i.e. low investor protection) transactions currently represent 80% of leveraged lending, up from 30% before the great financial crisis. Second, the recovery of investor capital from the companies that fail has declined significantly. According to a recent IMF blog post, the average recovery rates for defaulted loans have fallen to 69% from a pre-crisis average of 82%. Third, there has been a significant shift in the investor base, with a larger proportion of institutions such as mutual funds, insurance companies, pension funds and collateralized loan obligations (CLOs) buying and repackaging the debt.

Meanwhile, the high-yield debt picture remains encouraging. Net issuance of high-yield debt has declined over the past few quarters, and the share of high-yield bonds outstanding that are rated "deep junk" remains around 30%, well short of the peak of 45% in 2009 during the crisis. Furthermore, the spread of high-yield corporate bonds relative to Treasury securities remains relatively low from an historical perspective, reflecting low default rate expectations and lower excess bond premiums (the gap between bond spreads and credit losses). While these findings are encouraging for the sector overall, the total $1.2 trillion of outstanding high-yield debt represents a nonnegligible risk in the case of repricing.

As such, the risk is that broad-based downgrades of bonds, especially from investment-grade to speculative-grade could force investors to liquidate their positions leading to surging yields and straining corporate finances, possibly leading to defaults.

Looking further afield

The problem is not isolated to the US either. Leveraged loan issuance in Europe has been just as prevalent (chart right) with leverage levels now exceeding those in the US.

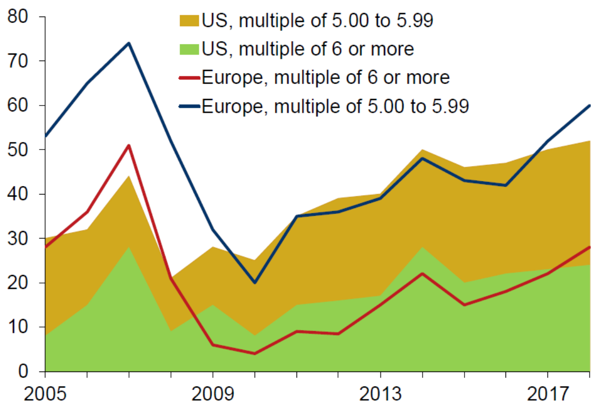
The investment grade credit market in Europe is under similar strain where the BBB share was only around 20% in 2011 but is also now around 50%.

Globally, the BBB share in investment grade credit has doubled from 24% in 2007 to 48% now.

One oft-cited features of companies today, especially US corporates, is the high level of cash balances held. In the US, however, although aggregate cash/debt ratios have improved in the last decade, over half of cash holdings belong to a tiny number of cash-rich firms. Outside this group, things look much less rosy. For investment-grade corporates outside the top 1%, the cash/debt ratio has deteriorated since 2010 and for speculative-grade borrowers it is lower than in 2006 (chart right).

US and Europe: Highly leveraged loans

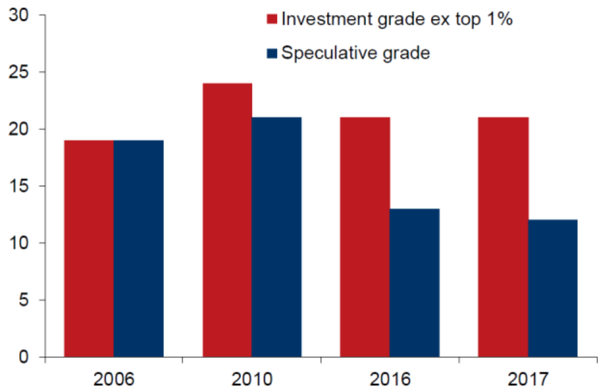
% of total leveraged loan issuance



Source : IMF GSFR

US: Corporate cash/debt ratios

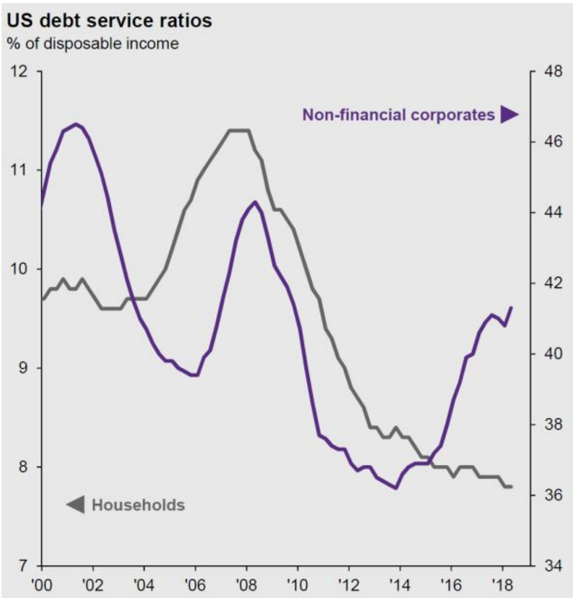
%

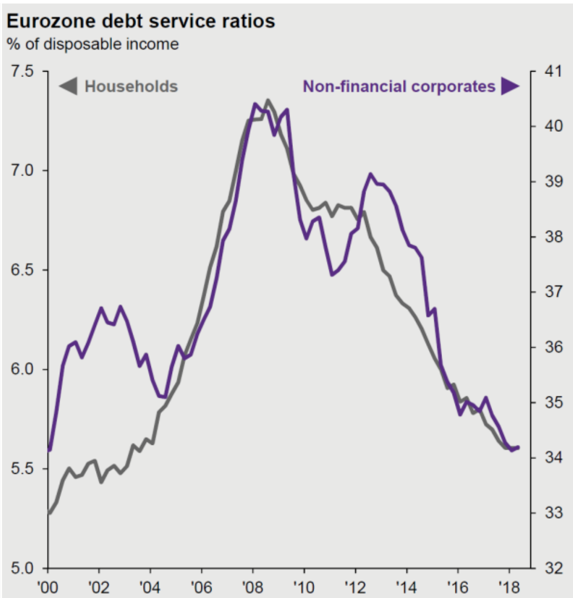


Source : S&P/Oxford Economics

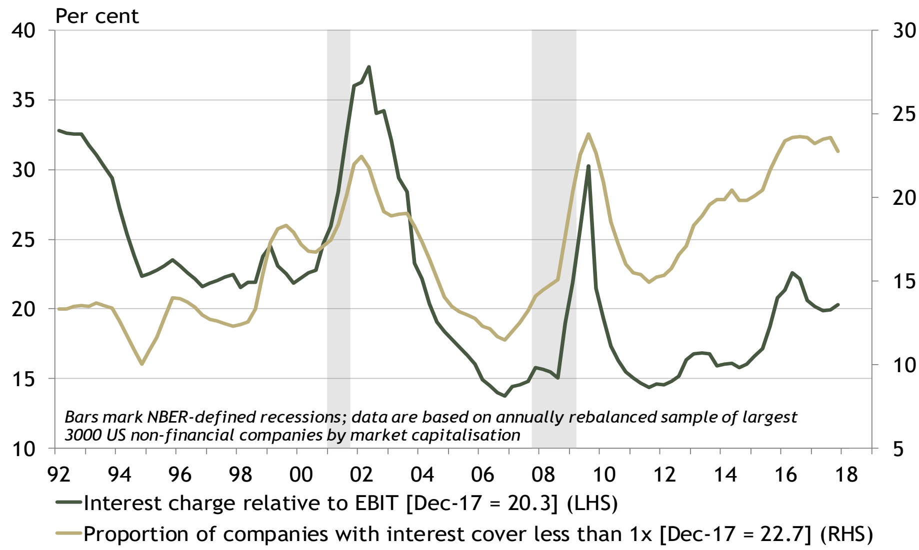
Low rates mean lower interest payments

One obvious counterargument to the risk is that since interest rates have been so low for so long, the amount of income required for paying interest expense is also lower. While this appears to hold water in Europe, debt service ratios in the US are currently rising.

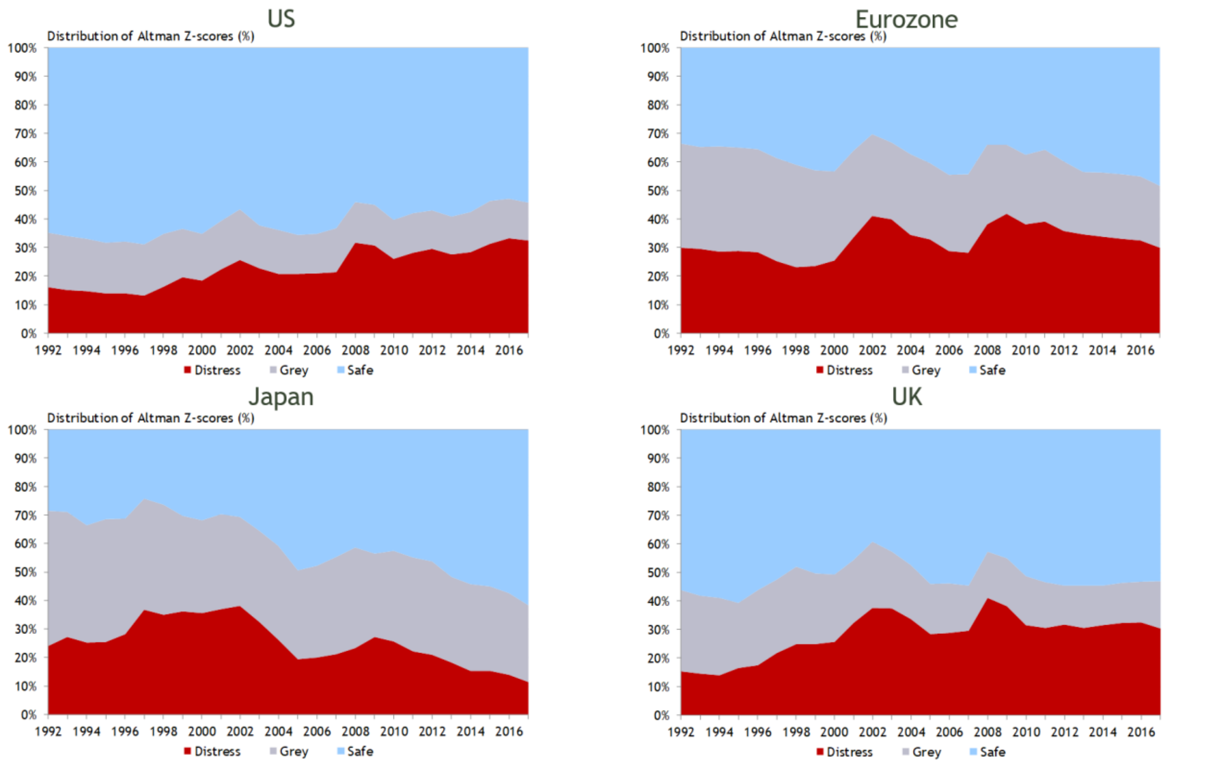




More worrying still is the proportion of companies with interest cover of less than 1 which is close to historic peaks. The difference between the aggregate data between well below peak and the high proportion of companies with a ratio far in excess of the aggregate is due to the distribution of cash, debt and consequently interest expense across industries.



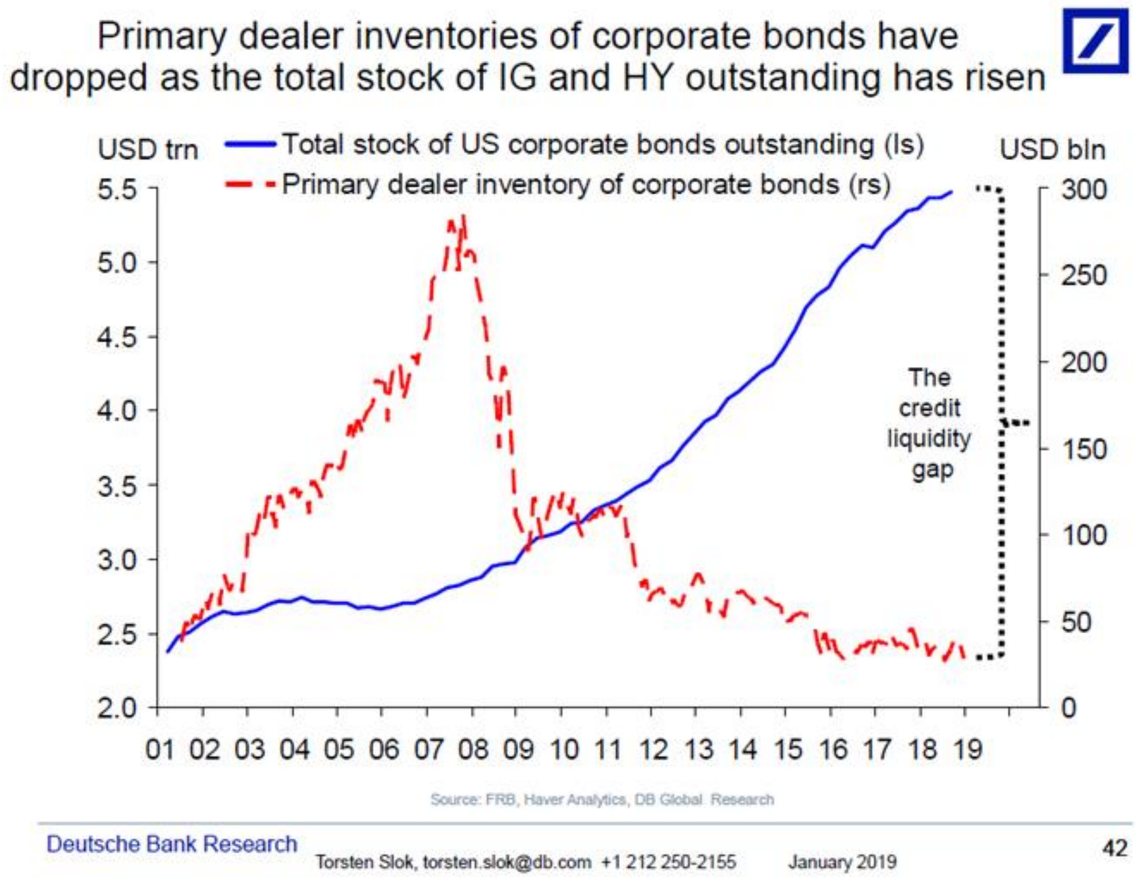
The 'Altman Z-score' provides a quantitative measure of a company's financial health. It is a simple combination of four or five ratios taken from a company's income and balance sheet accounts. A weight is applied to each of these ratios in a way that optimises the formula's capacity for predicting how likely it is that a firm goes bankrupt within two years. The Z-score is compared with threshold values that denote 'safe', 'grey' and 'distress' zones. The rising risk in US credit versus other regions is a key cause for concern.



Source: ASR Ltd / Refinitiv / Worldscope

Credit market liquidity

Finally, when speaking with bond fund managers we always hear about how bad the liquidity in the bond market has become. The chart below, borrowed from Deutsche Bank, speaks volumes.



Concluding remarks

An intensification of the recent growth slowdown and further drops in asset prices (perhaps resulting partly from the ongoing drain of QE) could also trigger an ‘accelerator’ effect with higher ratings downgrades and debt defaults.

Were this to occur in the US investment grade market, there is a risk of market seizure in the high yield segment given not only the two markets’ relative size differential that is at a stretched level but also due to the massive challenge of moving paper from one part of the market to another when dealers are unable and unwilling to make markets.

The tighter financial conditions that would undoubtedly ensue would lead to tighter bank lending conditions and increasingly cautious behavior by firms which would serve to further compound the issue.

This could look more like the 2001-02 experience than 2007-09, with over-indebted firms feeding back into weaker economic growth.