Bond markets

Too close to the sun?
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Bonds issued by riskier borrowers have soared as investors sought alternatives to American government bonds. But have they flown too high? This article looks at American corporate debt; the next, at emerging-market bonds

WITH a change of just two words, the Federal Reserve has sent the first real shivers through rising parts of America's financial markets, since they touched bottom in late 2002 and early last year. In previous announcements, the Fed had said that it would keep rates on hold for a “considerable period”. Now it says merely that it will be “patient”.

A subtle change, perhaps, and while no one expects America's central bank to put up rates sharply and quickly, markets are starting to think that short-term rates might rise from their 45-year lows a bit sooner than they had expected. A market that has more to lose than most from rising interest rates is one that has also been one of the most effervescent in recent months: the corporate-bond market. It has already dropped a bit since the Fed's announcement. Is this a brief sell-off, or a sign of worse to come?

Having been rattled by the uncertainty about companies' finances following the shenanigans at Enron, WorldCom and the like in 2002, the markets' confidence—and the desire for yield—returned in force. The investment-grade and high-yield (more commonly known as junk) bond markets both had their fastest rally on record last year, which is a little surprising,
given investors' fears about how ravaged companies' balance sheets had become.

The extra amount that investment-grade bonds yield compared with Treasuries has fallen by two-thirds from their high. But the prices of junk bonds have risen still more spectacularly. Over the same period, the spread offered on bonds rated Caa (ie, hugely speculative) has fallen from 19 points to five, enabling the most aggressive investors in junk (meaning those willing to buy the dodgiest credits) to turn in fabulous performances, and the investment banks that have been selling so many of them to make billions of dollars in profit.

Companies, especially those with stretched finances, have benefited hugely from the renewed appetite for their debt. Take Nalco an unprofitable company. In November, Nalco was able to issue bonds at 9%, notwithstanding a junk rating of a particularly lowly sort—a yield that could not have been matched by a company with a top-notch junk rating in 2002. No matter: the issue was more than four times oversubscribed and Nalco took advantage of unsatisfied demand by raising another $450m on January 15th on similar terms. Between March and December of last year, the spread of bonds issued by firms with the same rating as Nalco halved, to under five percentage points.

It is not just bond investors that have been falling over themselves to lap up any bond with a sniff of yield; banks have again joined the fray, too. At the end of 2002, with credit scarce and demand for it high, banks were able to push through much tougher lending terms. They started to reduce the maturity of their loans from five years to three and often to one, and to charge more for them. They also raised the price of guarantees to provide funds to companies unable to tap the short-term commercial-paper market. These guarantees had been woefully underpriced since companies typically resorted to them only when they got into trouble.

Banks' new-found toughness did not last long, however: demand for loans has been falling sharply, and they have been keen for business. By the middle of last year, says Meredith Coffey of the Loan Pricing Corporation (LPC), a research firm, the number of companies able to push the length of their loans to five years had jumped from about 15% of the total to 30%. Now the figure is higher still, the average number of banks participating in syndicated loans has jumped sharply, and all thoughts of charging a decent price for a loan have evaporated.

As with the bond market, the generosity of bankers has been a boon for troubled companies. Last year, according to the LPC, at least a dozen companies refinanced far more cheaply loans which they had taken out only recently. The car parts division of TRW, a big conglomerate, is one. This was spun off in a leveraged buy-out early last year. As a business, it leaves much to be desired, since it relies on a limited number of buyers and had a not-especially-good junk rating. Yet in July, only months after being spun off, it refinanced $1.1 billion in debt, lowering the interest charge from four percentage points over LIBOR (the benchmark rate at which the best banks lend to one another) to three, saving $11m in annual interest costs. By December, the market had improved enough to enable the company to refinance again, this time lopping another half point off its interest costs, and saving another $5m a year in interest.

To be sure, there has been a sharp fall in the risks run by lenders of any sort and hence the returns they require. For one thing, default rates for junk have dropped to 5% of outstanding bonds over the past 12 months compared with their peak of 23% in November 2002. Given the strong economy, defaults should drop further. But these are a lagging indicator of risk. A better measure is to look at forward-looking market indicators. These, too, have improved. Equity prices have risen for many companies, thus reducing their leverage, as measured by the price of their equity compared with their
outstanding debts. The latter have fallen somewhat, too, because companies have been using record profits to pay off some debt.

**Default's an option**

More important has been a fall in the uncertainty about profits and share values. Bond investors hate an uncertain profit outlook because it means they are less likely to get their money back. But corporate profits surged 23% last year, helping to make investors far more comfortable. A good way of measuring this is to look at the options market, where prices have fallen dramatically. A commonly used measure is the VIX index of implied volatility (roughly, how much shares are likely to move around), which has fallen from a high of over 40% in October 2002, to a low of 14% last month—its lowest level since 1996. Because of the fall in both leverage and volatility, Moody's KMV, a subsidiary of the big ratings agency, predicts that the likelihood of an average company defaulting over the next year has fallen to just over 1%—a dramatic fall from two years ago.

Will risks rise when interest rates do? They have already done so a bit: the VIX has risen to just shy of 18%. But if the overall fall in volatility is the result of bumper company profits and enthusiasm for shares, it may rise higher still. Shares are still expensive by most historic yardsticks, and the fall in volatility sits ill with the wide range of year-end targets for the S&P 500 index for the end of the year.

Moreover, cheaper borrowing costs have (among other things, such as low taxes) clearly flattered profits, especially those at financial firms, which account for a third of all profits. And though companies have paid off some debt, they have not paid off as much as some might like to believe. In part, this is why the rating agencies are still downgrading more companies, with the exception of financial firms, than they upgrade. The recent surge in mergers and acquisitions, some of it financed with debt, suggests that companies are again more concerned with boosting returns than with the state of their balance sheets. All of this is bad news for bondholders.