Economic Perspectives

The coming collapse of corporate credit

A bull market in broken promises

Peter Warburton

Assisted by Yvan Berthoux and Tom Traill

10 October 2019

Summary (1)

- Highly indebted, under-performing, companies have enjoyed ready and affordable access to bond and loan funding since 2013
- Epicentre of the upcoming crisis is the leveraged loan/CLO market, but expect a delinquency epidemic in illiquid HY debt and heavy drawdowns in the price of over-rated BBB debt
- A loss of global corporate earnings momentum, aggravated by margin sacrifice in the context of trade tensions, will send the weak to the wall – large and small

Summary (2)

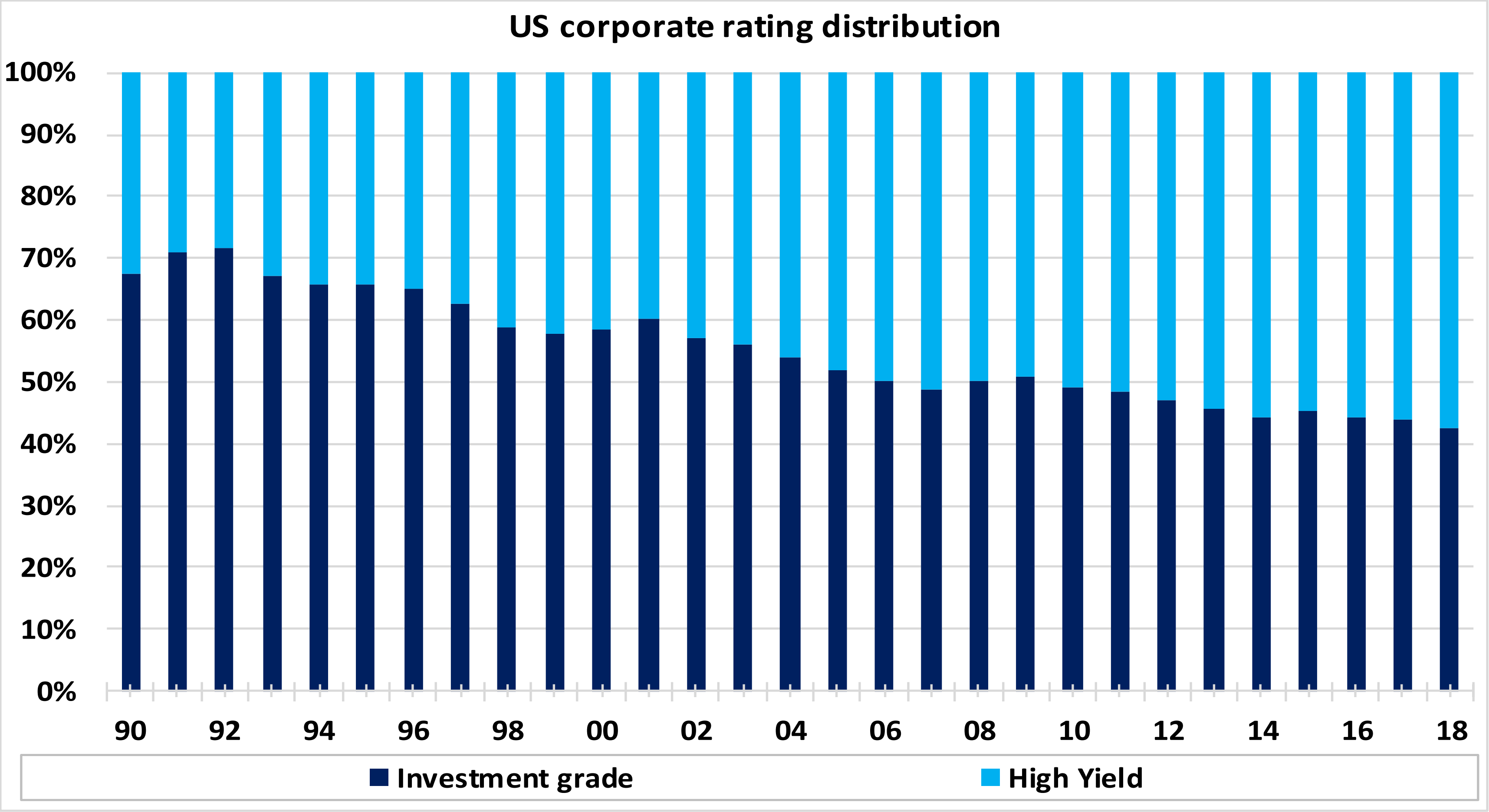
- Illiquid bond premiums are blowing out for both IG and HY as investors sense danger
- Corporate credit is bifurcating, with sound credits still pricing off the government curve but a long, fat tail of credits pricing illiquidity and default risk
- Widening credit spreads will trigger the end of the global economic expansion and there will be aggravated employment and capex impacts
- Central banks can protect the core of the financial system, but not the periphery

Unravelling of the Greenspan-Bernanke era

- Greenspan's vision of an ever-expanding risk universe: "if risk is properly dispersed, shocks to the overall economic system will be better absorbed and less likely to create cascading failures that could threaten financial stability." 25 September 2002
- Bernanke: "I am confident that the Fed would take **whatever means necessary** to prevent significant deflation in the US". "A central bank … retains considerable power to expand aggregate demand **even when its accustomed policy rate is at zero**" 21 November 2002

Open all hours: even the GFC did not curtail market access

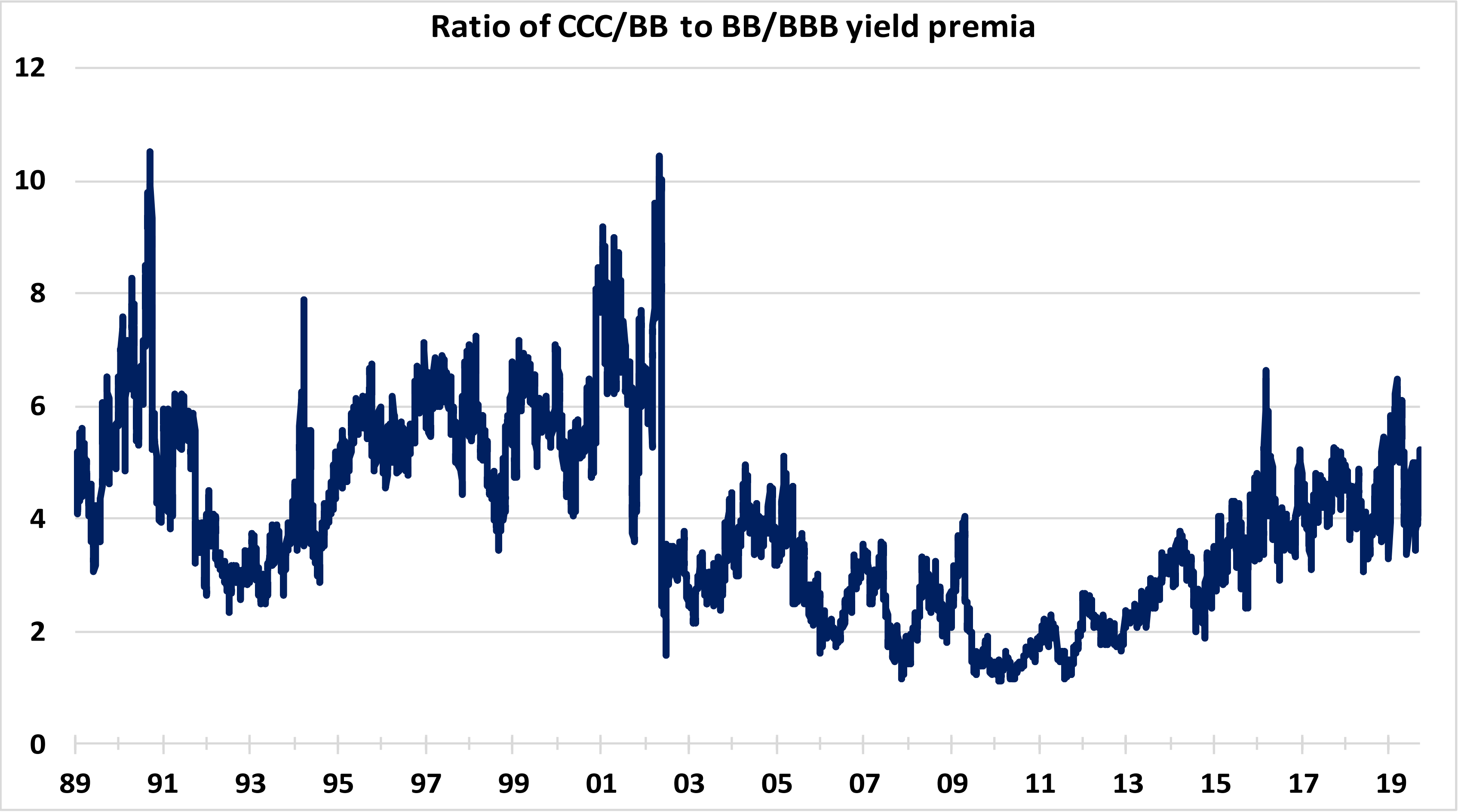
- Confident expansion of HY issuers from 2003



Data Source: Standard and Poor's

Greenspan-Bernanke's interventions in 2002

- Markets are repricing default risk at the margins



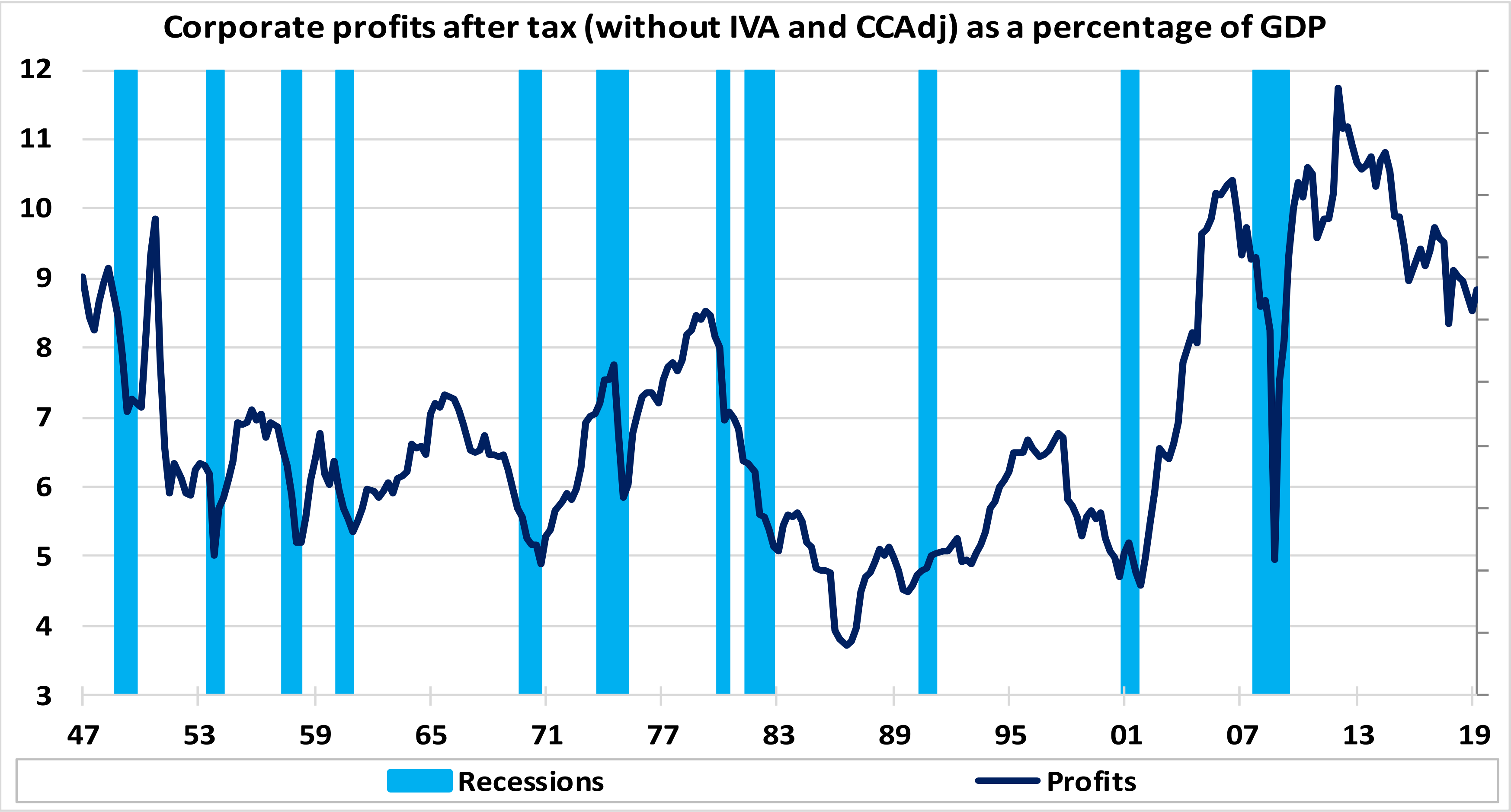
Data Source: Eikon Reuters

Ultra-easy credit did not block corporate profits downturn

- Rapidly approaching the point of no return!
- US NIPA after-tax profits share in GDP is falling
- Japanese profitability is waning
- Operating profits squeezed by rising labour and materials costs
- Analysts' earnings revisions are tilting lower
- Flattening yield curve predicts weaker profits
- Tariff wars are highly destructive to profit margins as stronger firms delay passing on higher costs

Context: falling profitability momentum

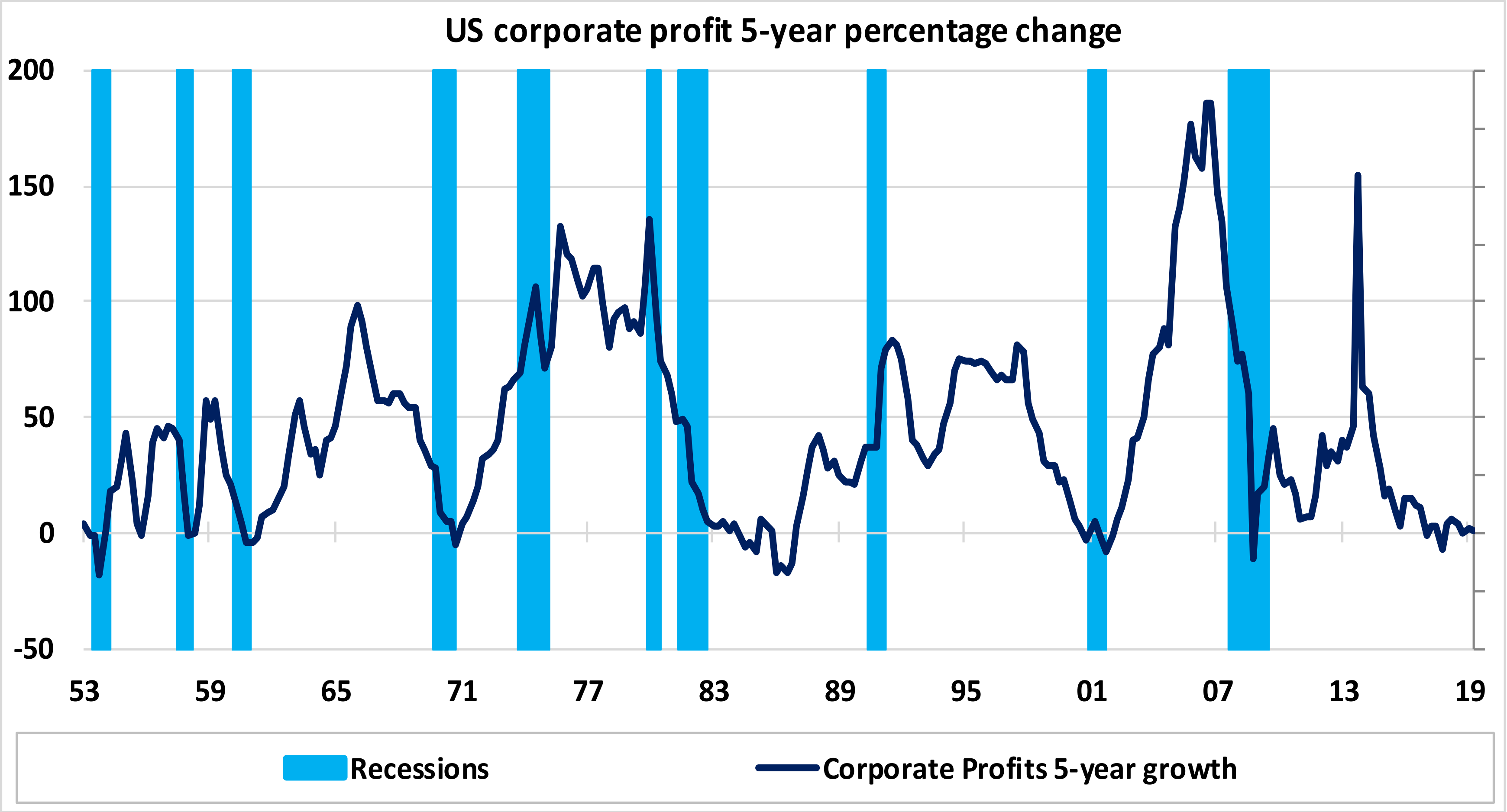
- US NIPA after-tax profit share is tumbling



Data Source: St Louis Federal Reserve

Context: US corporate profits on the cusp of decline

- Squeezed by rising labour and materials costs



Data Source: St Louis Federal Reserve

Context: Japanese corporate profitability under pressure

- Topix EPS estimates down 8% from October 2018

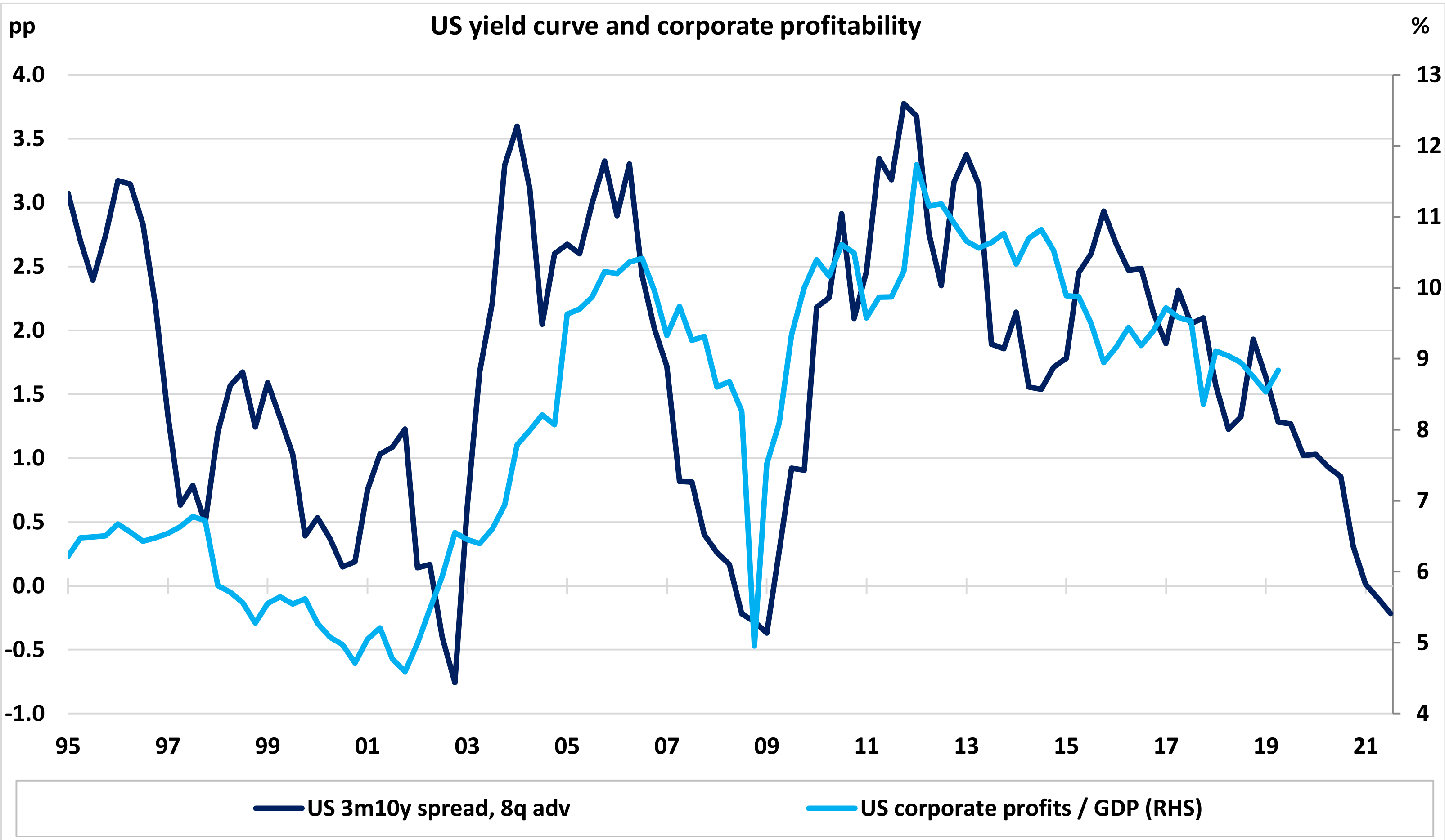
Japan's non-financial corporate recurring profits to sales ratio (%, SA)

Source: Morgan Stanley

Economic Perspectives

Dynamics: yield curve inversion leads a profit crunch

- Profit rate has much further to fall



Data Source: Eikon Reuters

Economic Perspectives

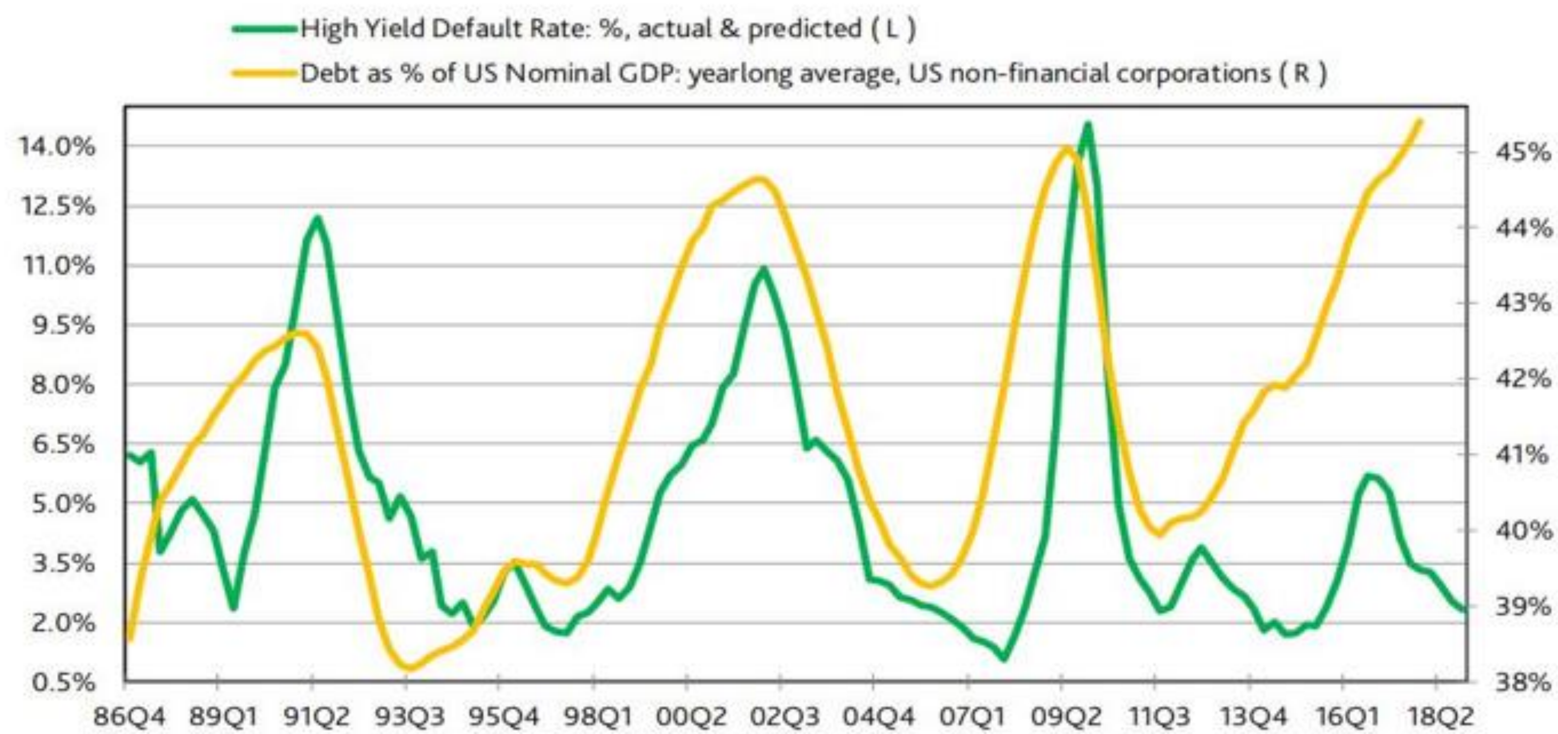
Financial repression equals default rate suppression

- Zero interest regimes fostered bad lending practice
- The long reign of ‘extend and pretend’
- Rolling up of interest into principal, requiring no debt service payments
- Forbearance for favoured customers
- Disguising non-performing loans as sound
- Capitalising problem loans into ‘vehicles’
- Avoiding credit ‘events’ that trigger CDS payouts
- Compression of credit spreads under weight of international investors’ search-for-yield

Financial repression separates leverage & default cycles

- Access to easy credit permits interest roll-up

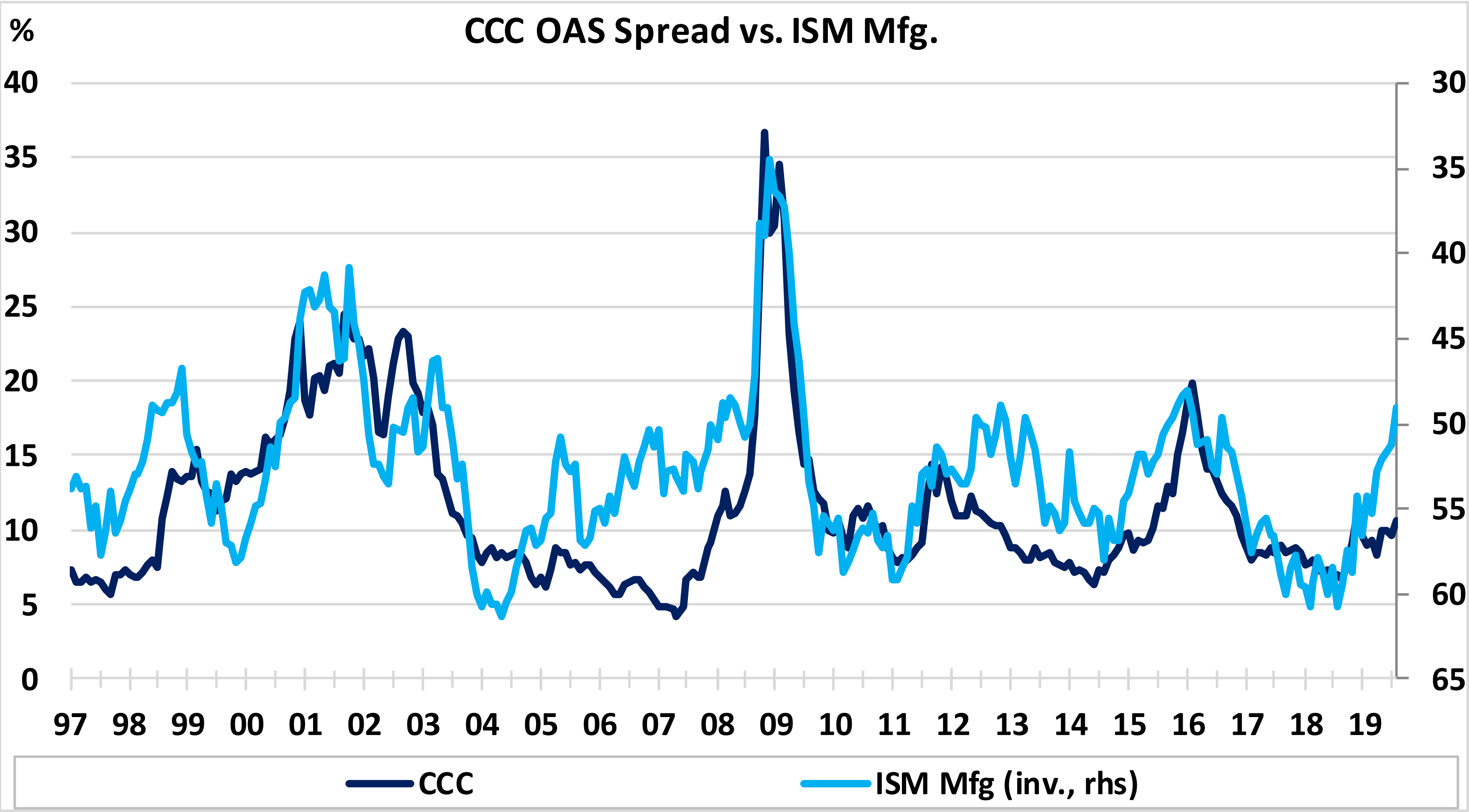
Default rates HY vs. corporate debt to GDP ratio



Source: Moody's

Suppression of bond default is drawing to a close

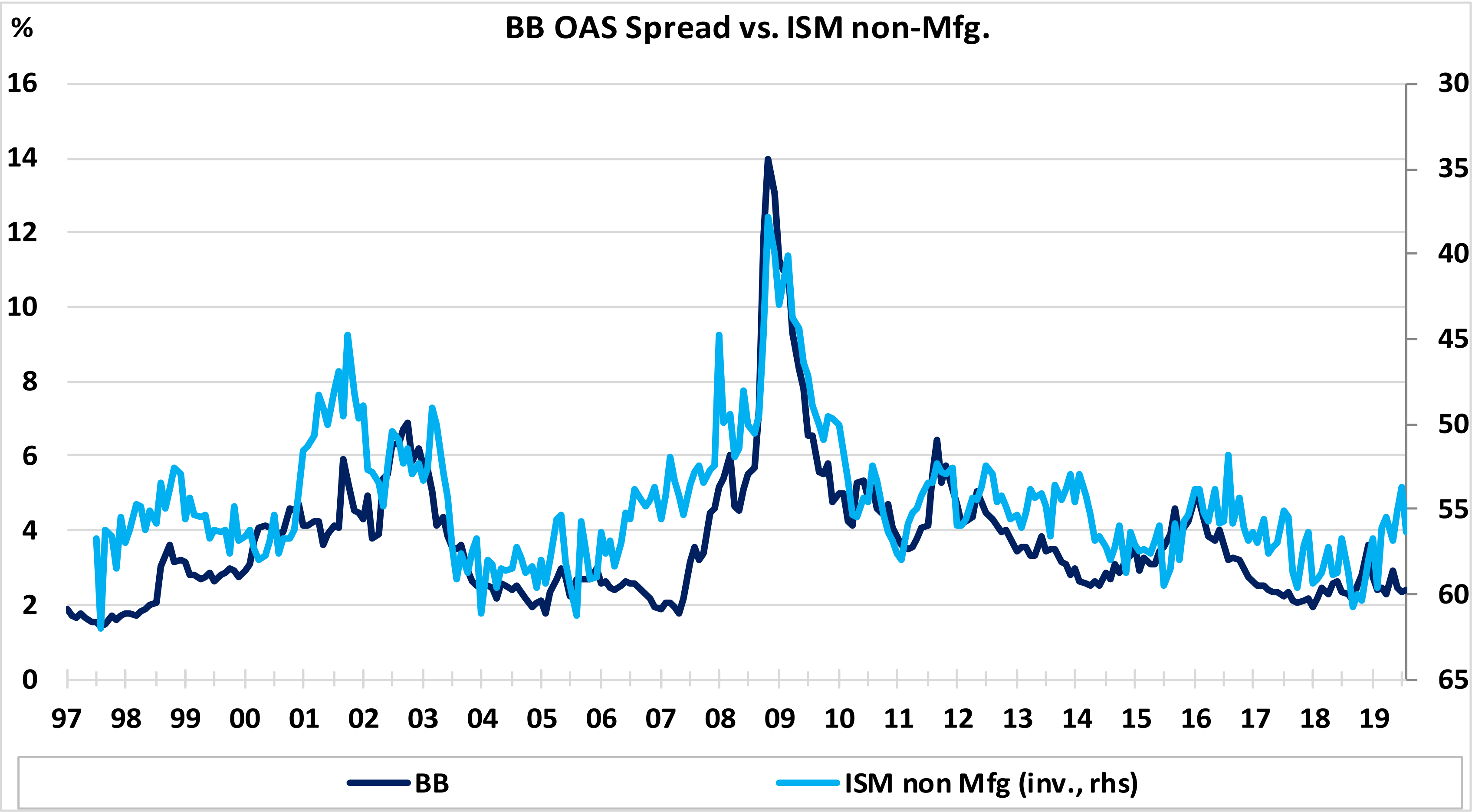
- Investors in HY debt will soon be running scared



Data Source: Eikon Reuters

HY issuers in less cyclical sectors will fare better …

- … but BB-rated bonds only offer relative safety



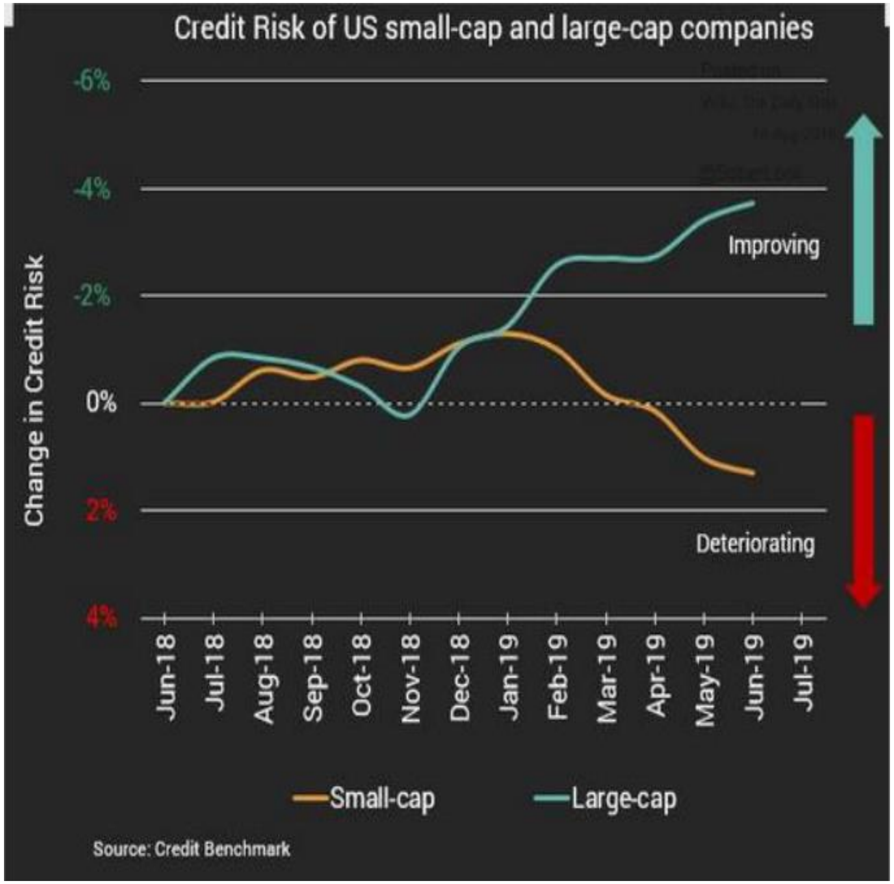
Data Source: Eikon Reuters

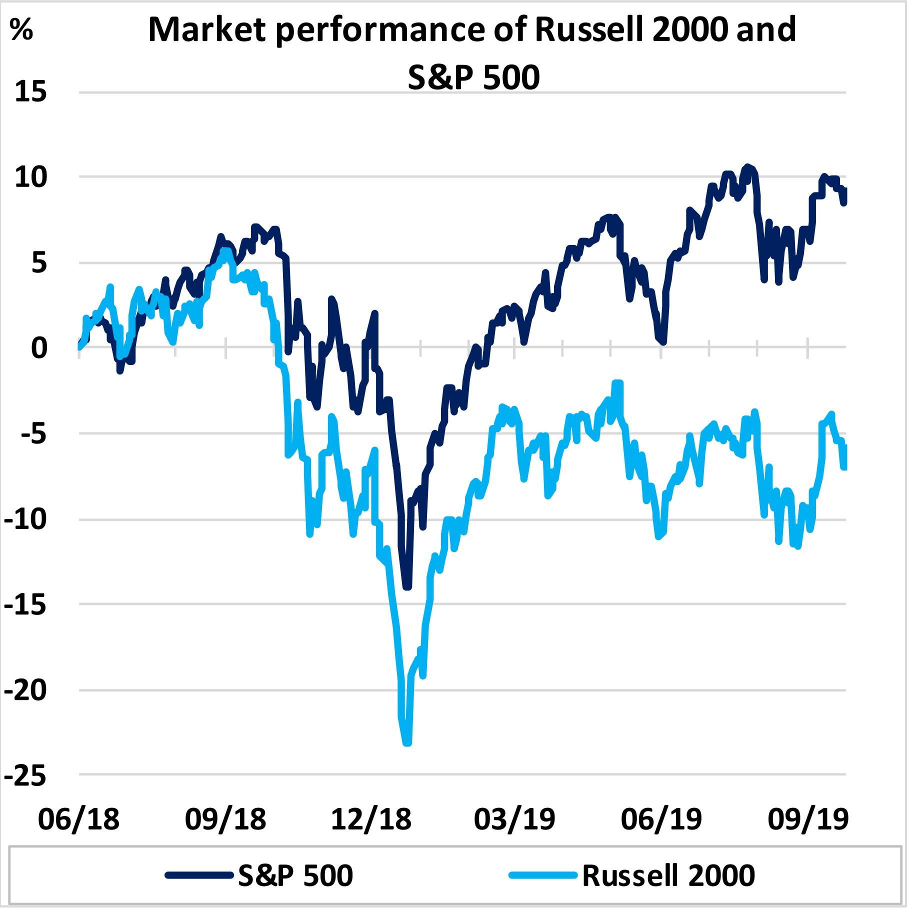
Cost of 'turning off the fire alarm'

- Failed macro-policy framework has fuelled divergence and risk concentration
- Pronounced skew in profitability between market leaders and the rest: strong are getting stronger
- Credit risk multiplying for small-caps and SMEs (small-cap debt-equity ratio now exceeds high-cap)
- Spreads are rising disproportionately for weaker credits (eg CCC vs BB)
- Illiquidity premiums are rising for IG and HY bonds
- End of "open all hours" for private credit issuance

Bifurcation in US corporate credit risk by size

- Profits downturn will accentuate divergence

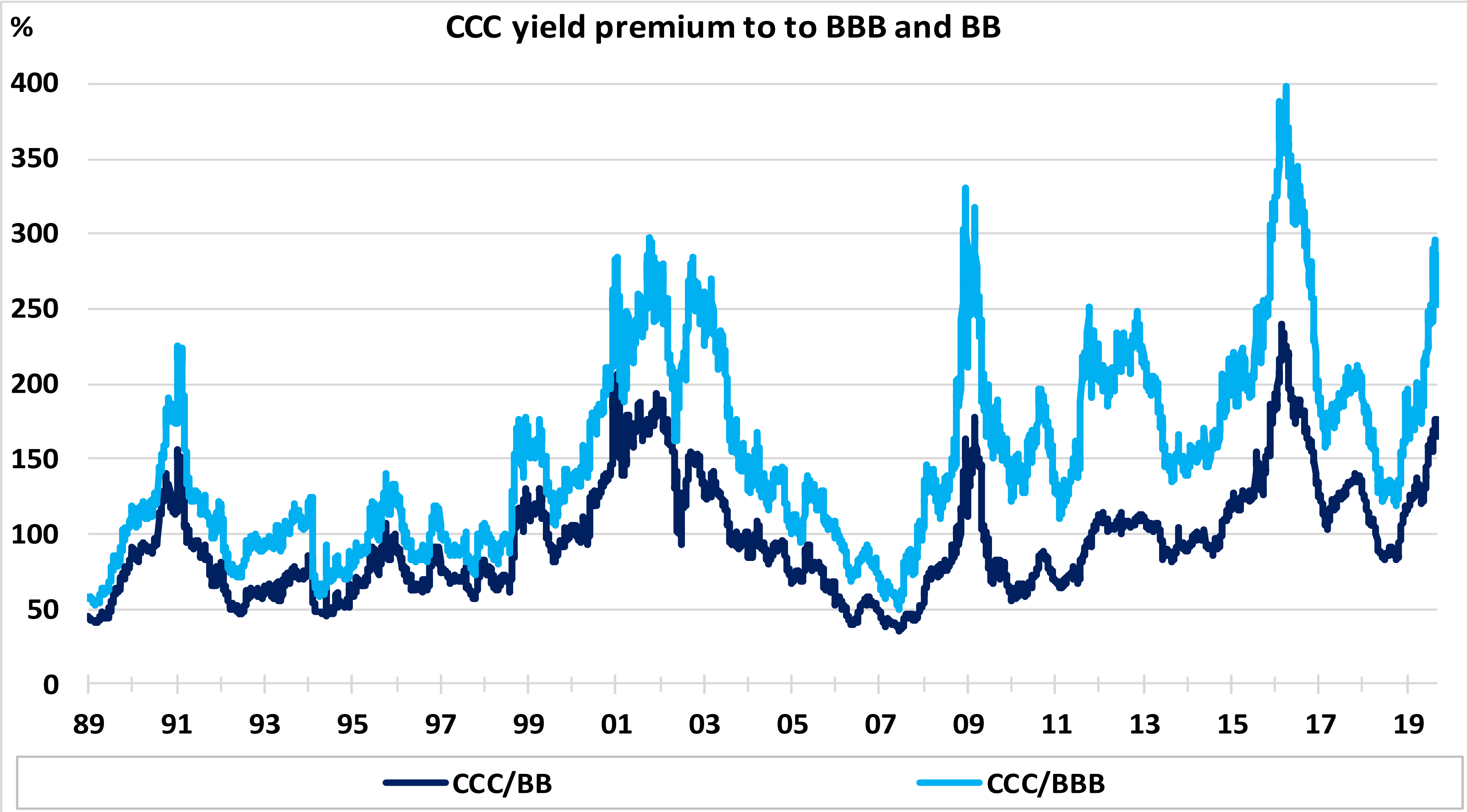




Data Source: Credit Benchmark, Eikon Reuters

Risk accumulating at the fringes of the debt universe

- Building up to the “Big One”



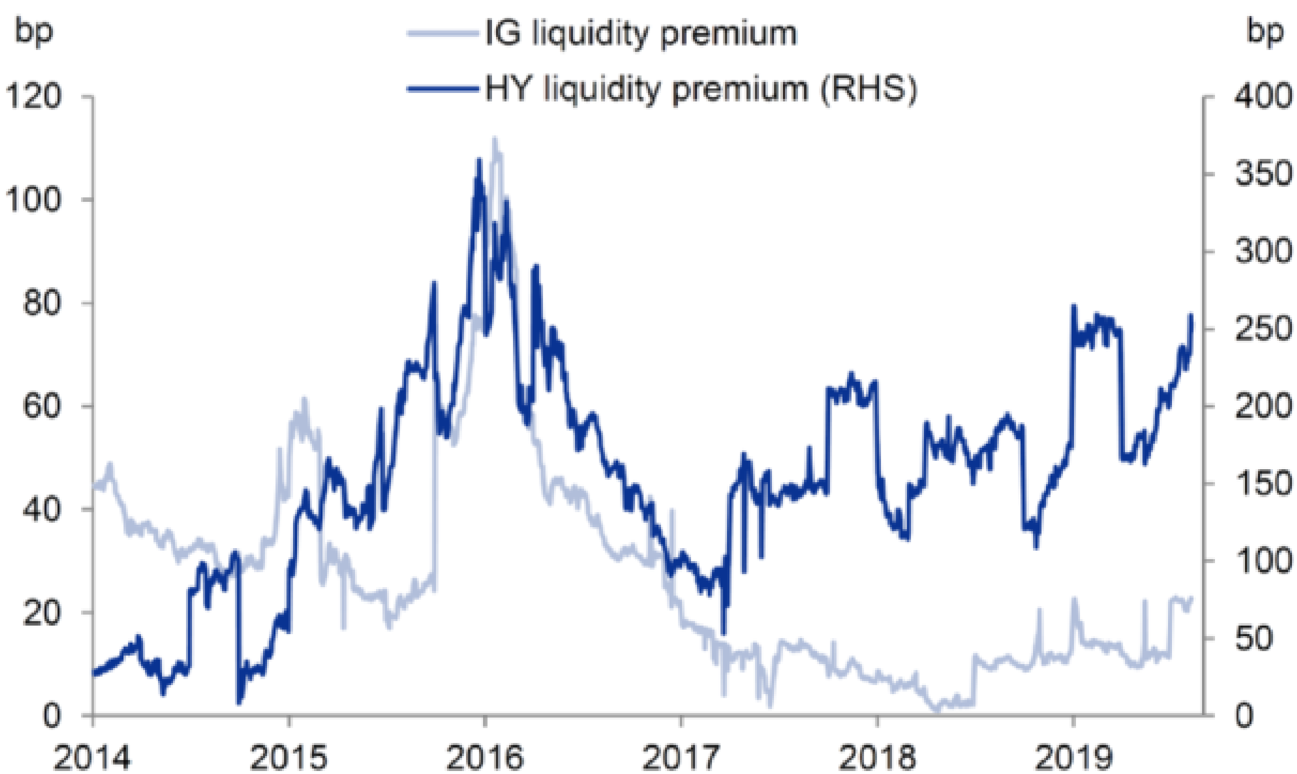
Data Source: Eikon Reuters

Rising tide of untraded and untradable corporate bonds

- Recovery rates on default will be very low

Exhibit 1: In both IG and HY, the premium provided by illiquid bonds has been drifting wider

Average spread differential between illiquid and liquid bonds in IG and HY



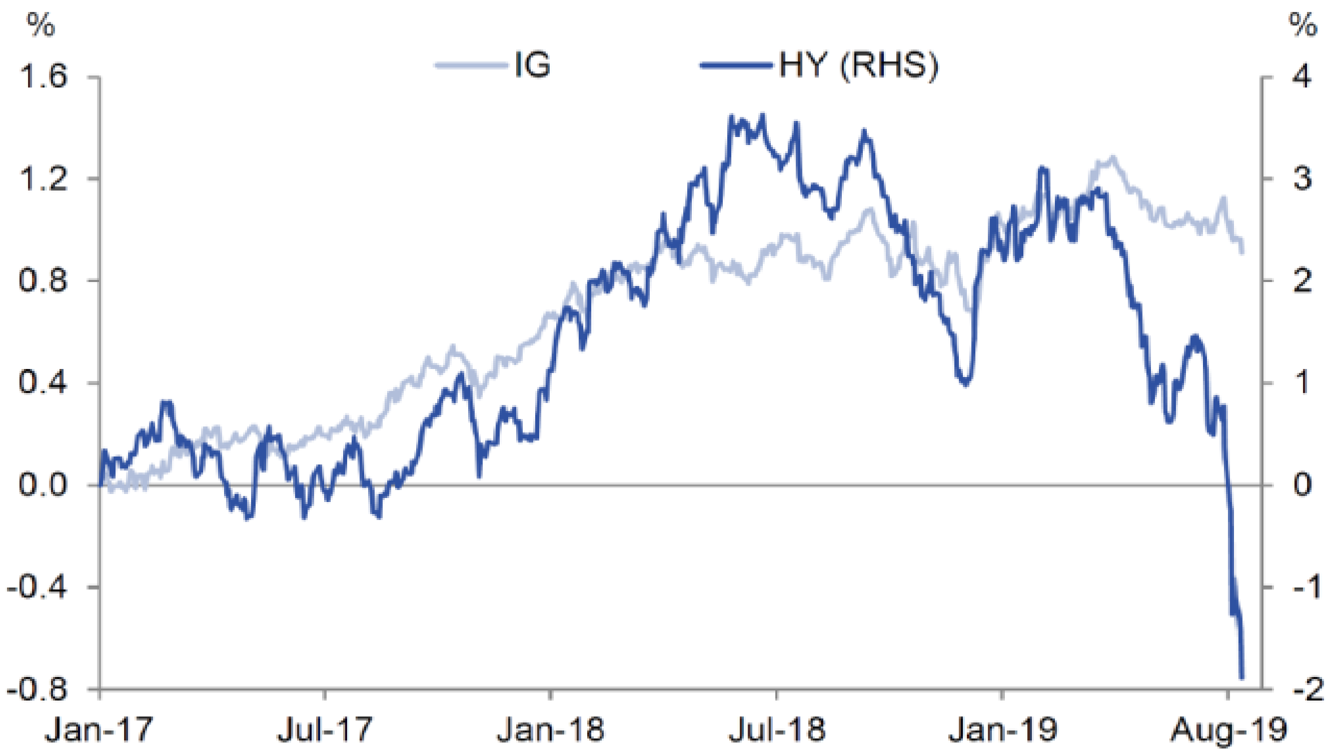
Source: BAML

Illiquid HY bonds: there is no exit strategy

- The end of “open all hours” for private credit

Exhibit 2: The underperformance of illiquid bonds has been particularly pronounced in HY

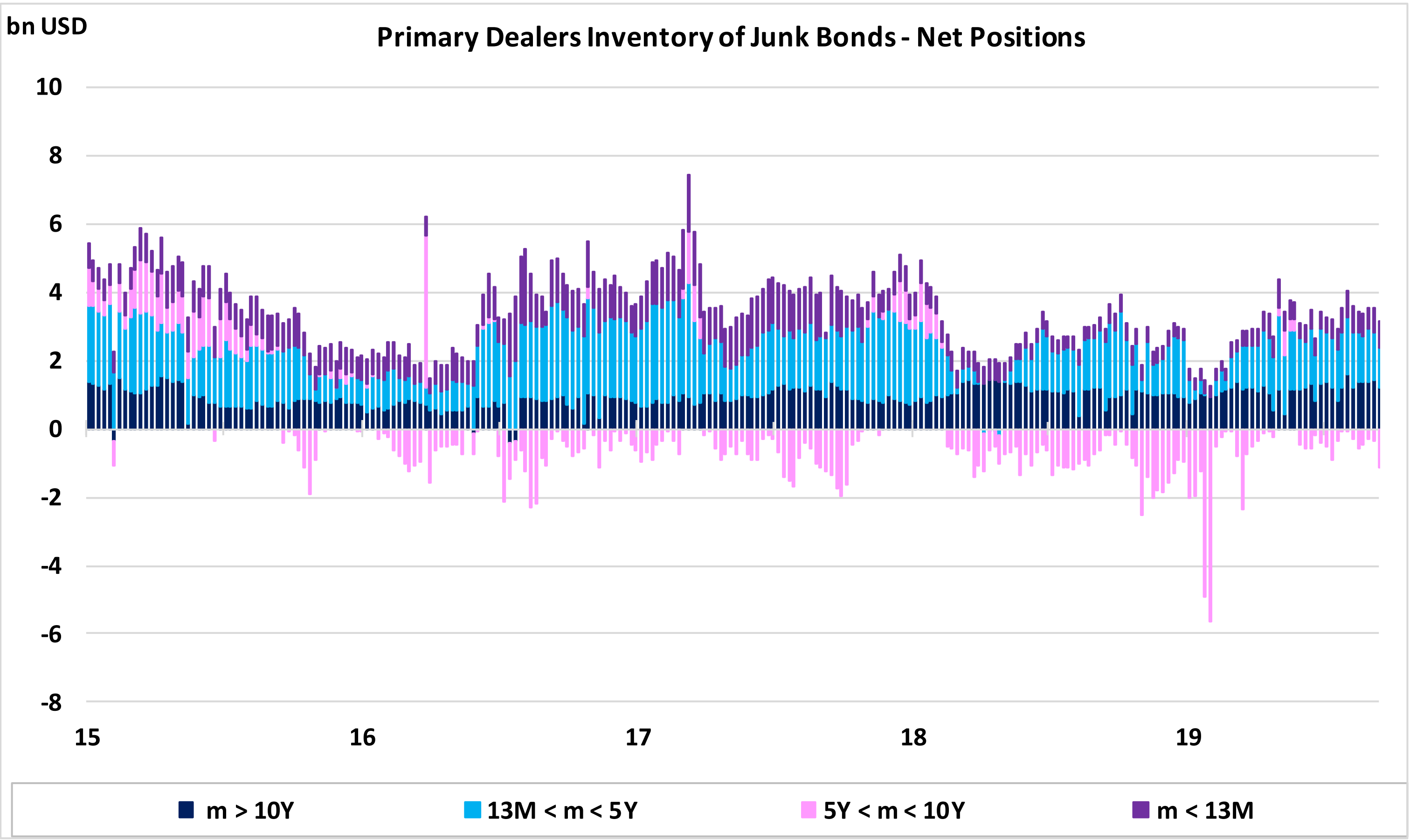
Cumulative excess return on long-short illiquid vs. liquid IG and HY bonds portfolio (rates-hedged)



Source: BAML

There is no buyer of last resort for HY bonds (or HY funds)

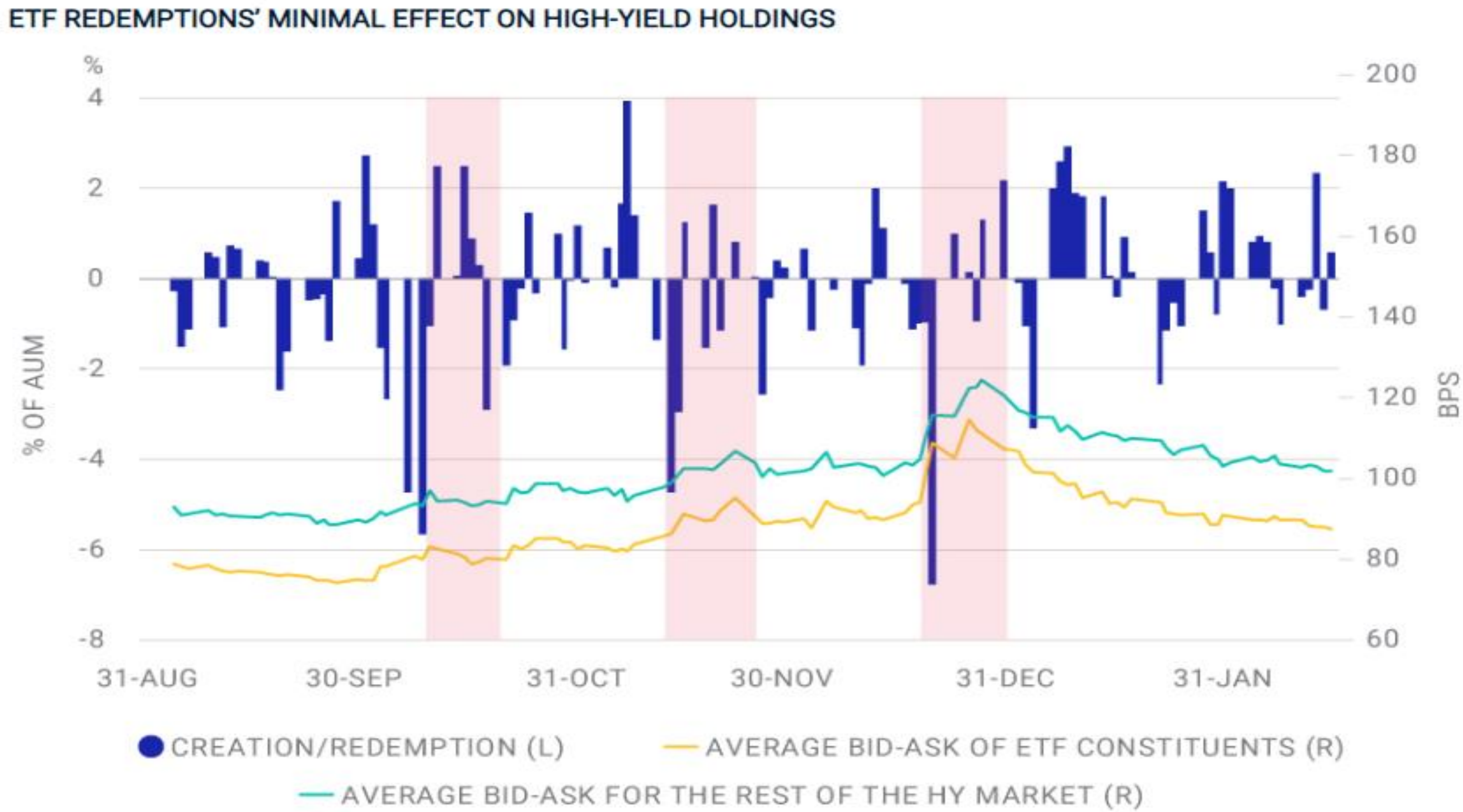
- Financial regulation has enhanced pro-cyclicality



Data Source: NY Fed

Liquidity mismatching in HY debt funds

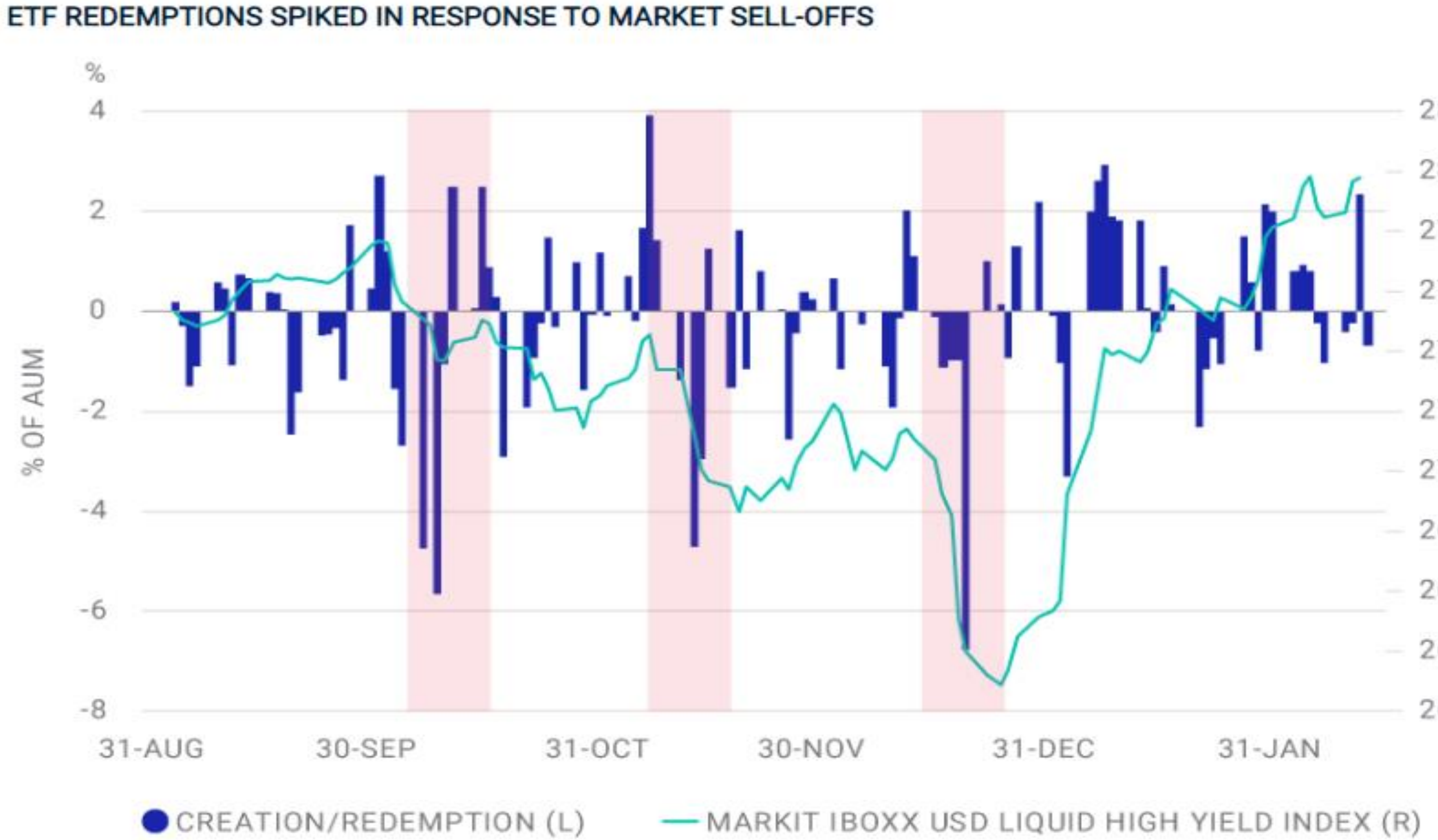
- Bid-ask spreads will soar in a real crisis



Source: MSCI

Rehearsal of the dash for the HY ETF exits in Q4 2018

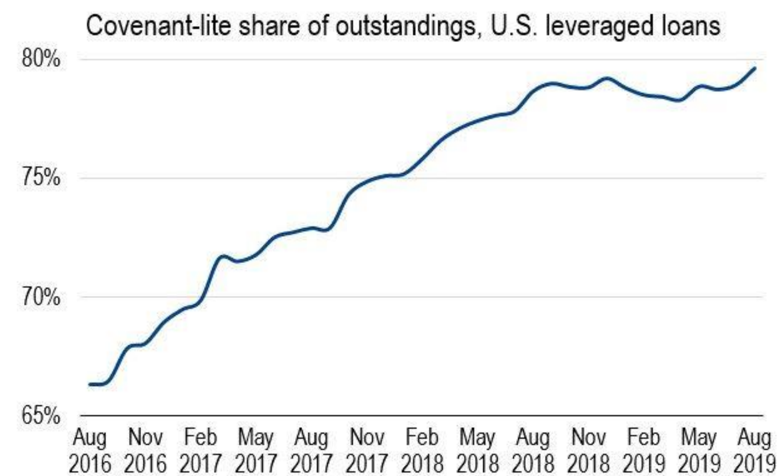
- You ain't seen nothing yet!



Source: MSCI

Leveraged loans are a focus of concern

- Global leveraged loans c. $2.2trn (BoE estimate)
- US leveraged loans (mostly cov-lite) c. $1.4trn
- CLOs (non-mark-to-market) c. $750bn
- Very rapid market growth
- Median credit rating is B
- Issuance window closing
- Discounts offered to facilitate new issues
- Negative performance

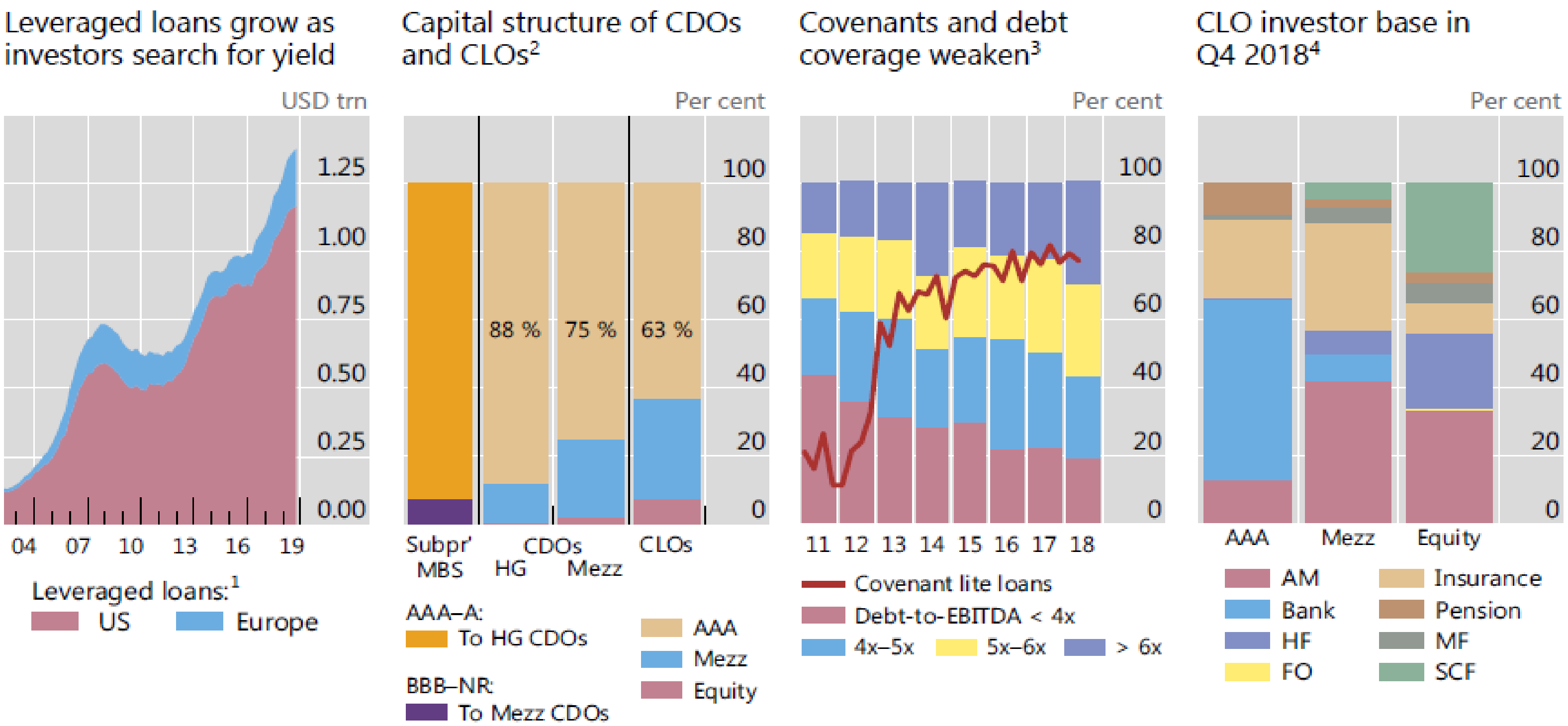


Source: LCD, an offering of S&P Global Market Intelligence

Weak credits are buried in illiquid structures - again

- CLOs are non-mark-to-market by design

CLOs improve on some CDO failings, but vulnerabilities remain — Graph B

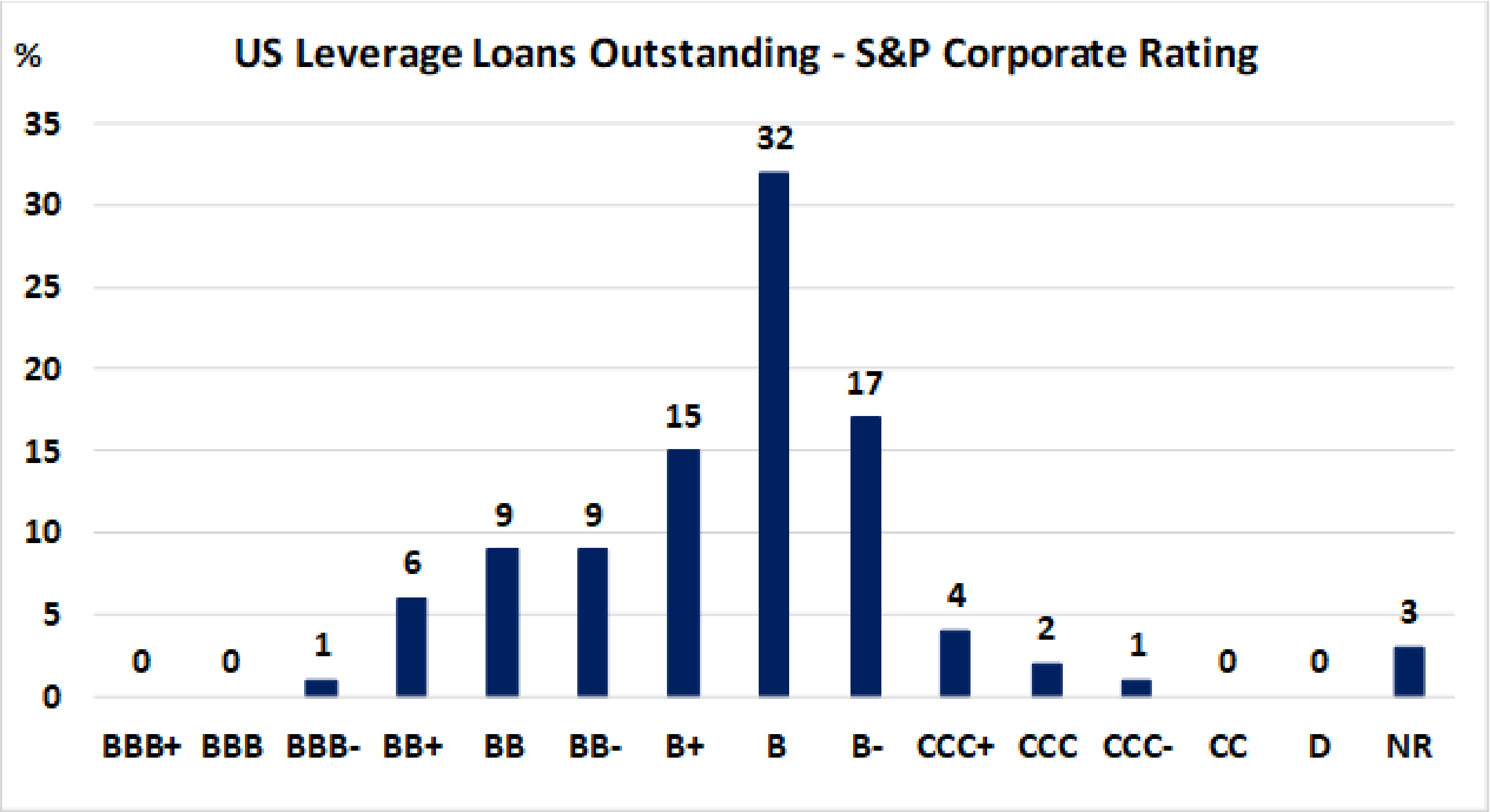


AM = asset managers; EBITDA = earnings before interest, taxes, depreciation and amortisation; FO = family offices; HF = hedge funds; HG = high grade; MBS = mortgage-backed securities; Mezz = mezzanine; MF = mutual funds; NR = not rated; SCF = structured credit funds.

Source: BIS

Leveraged loans sit at the epicentre of the coming storm

- No security, no covenant, no chance

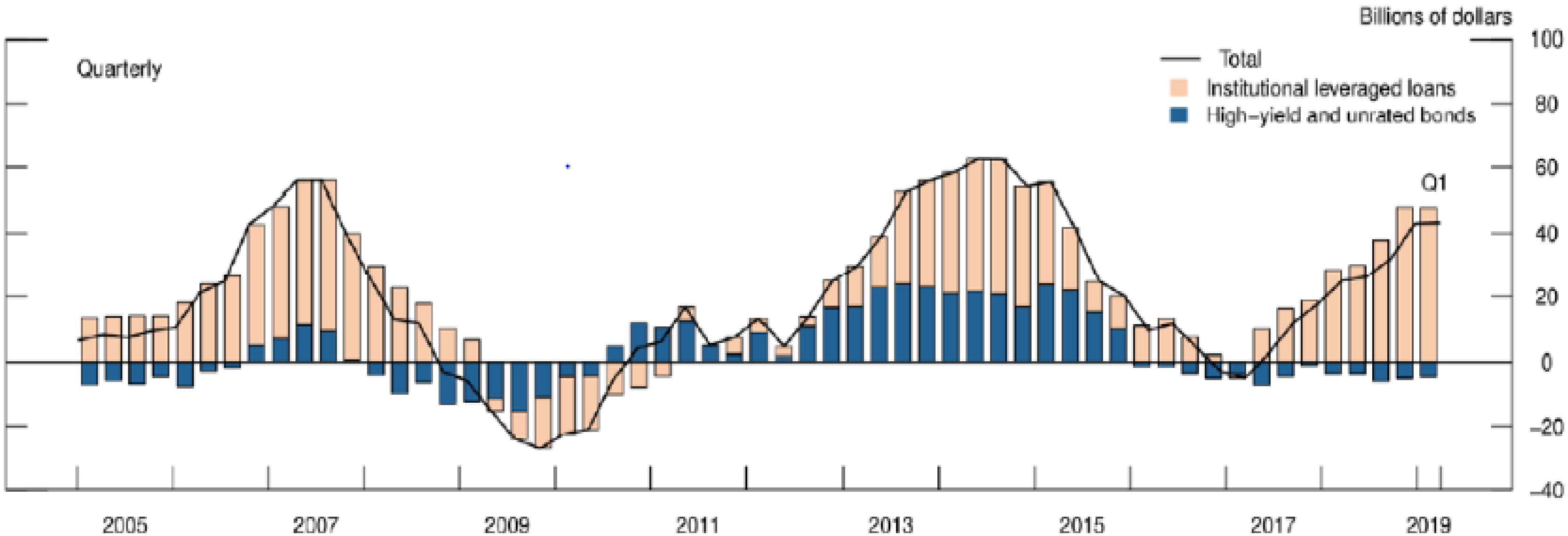


Source: S&P

Speculative debt issuance: the late-cycle rush

- How long before the issuance window closes?

Figure 3
Net Issuance of Risky Business Debt

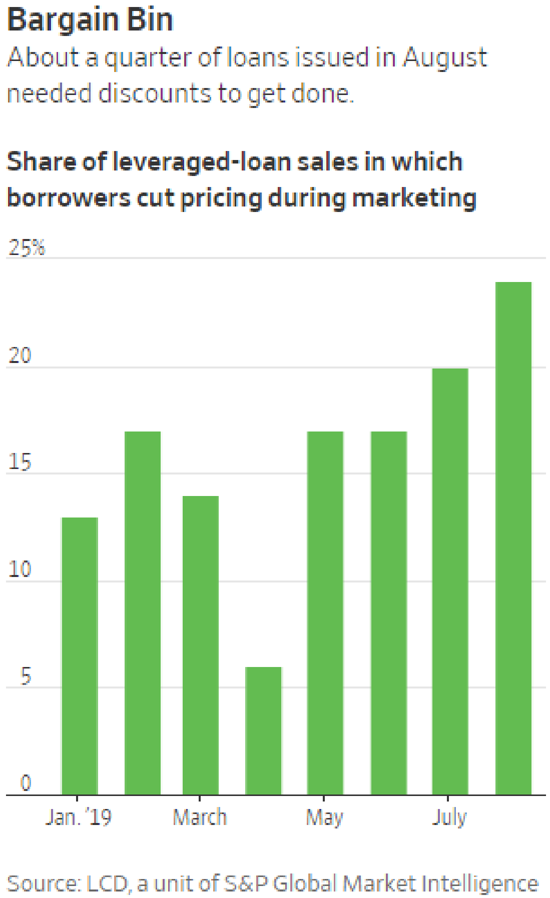


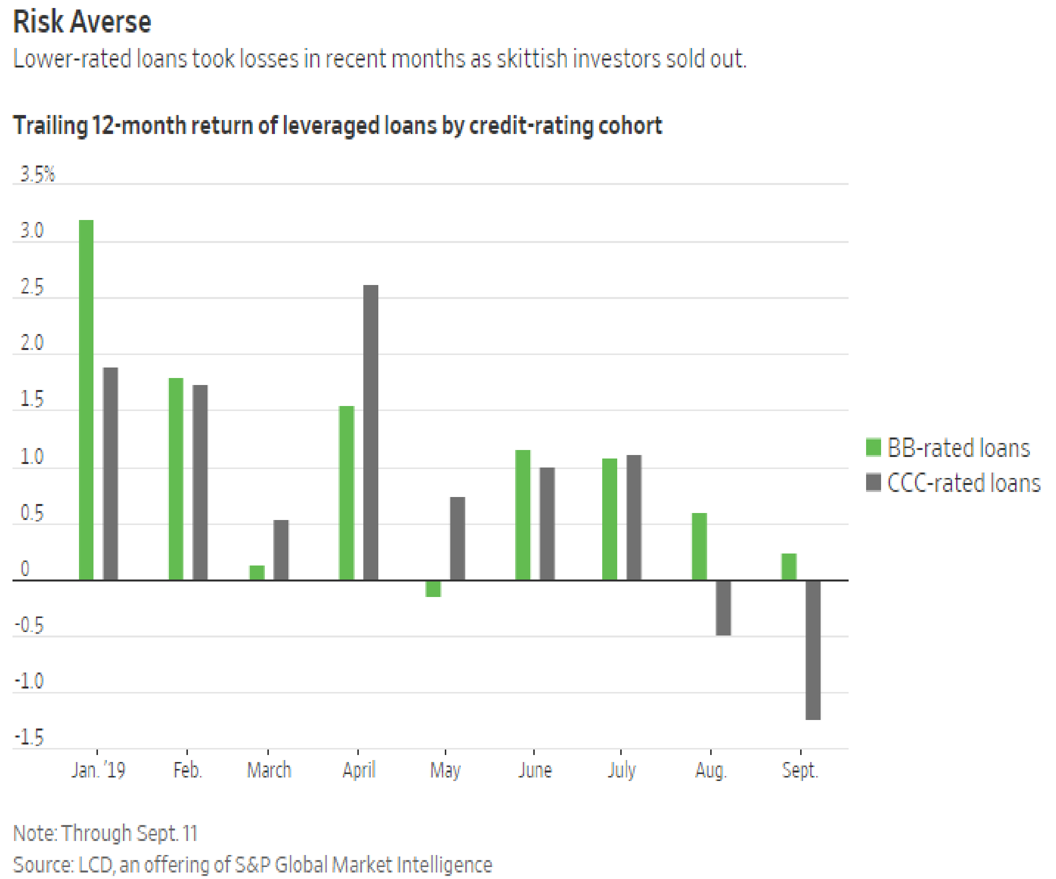
Note: Total net issuance of risky debt is the sum of the net issuance of speculative-grade and unrated bonds as well as leveraged loans. The data are four-quarter moving averages.
Source: Mergent, Fixed Income Securities Database (FISD); S&P Global, Leveraged Commentary & Data.

Source: Federal Reserve

Leveraged loans: growing signs of fatigue

- Risk-reward trade-off has soured





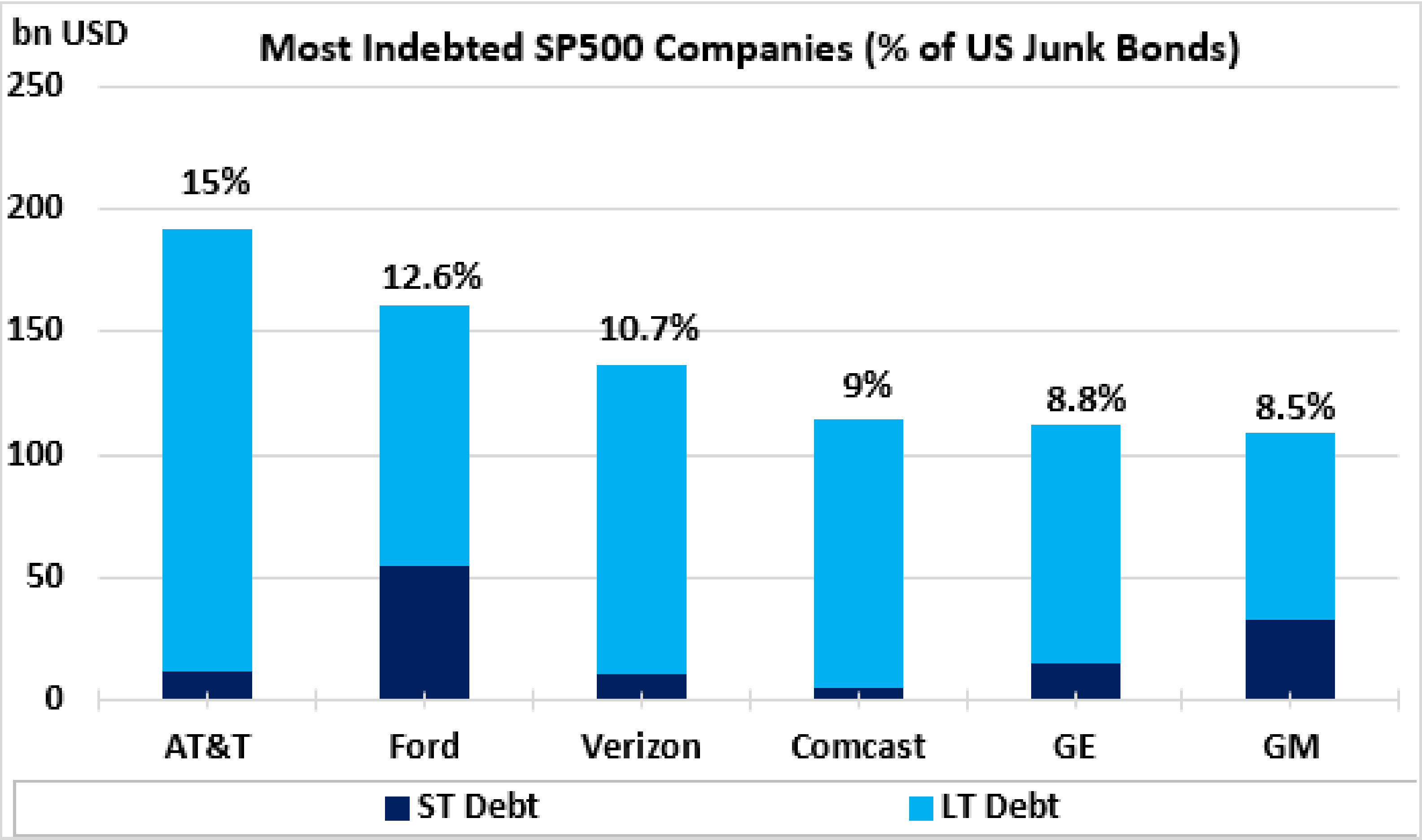
Source: S&P

Serious credit problems lurking in triple-B tranche

- Ratings of very indebted companies are leavened by large weightings to non-balance sheet metrics
- Deteriorating business performance – eg auto, retail, telecom sectors – not yet fully reflected in bond ratings
- Big borrowers vulnerable to bad news on profitability and earnings guidance
- Investors likely to rush towards the exits in illiquid secondary markets
- Triple-Bs can easily be ‘downgraded’ to *de facto* junk

Triple-BBB giants most at risk of debt re-pricing

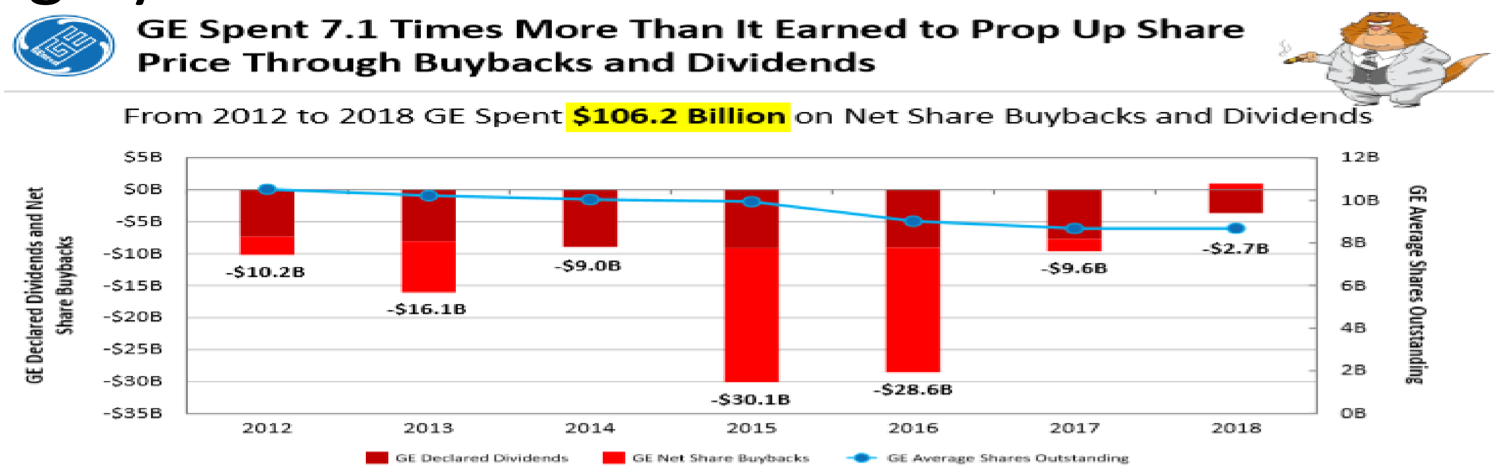
- *De-facto* downgrade would overload junk universe

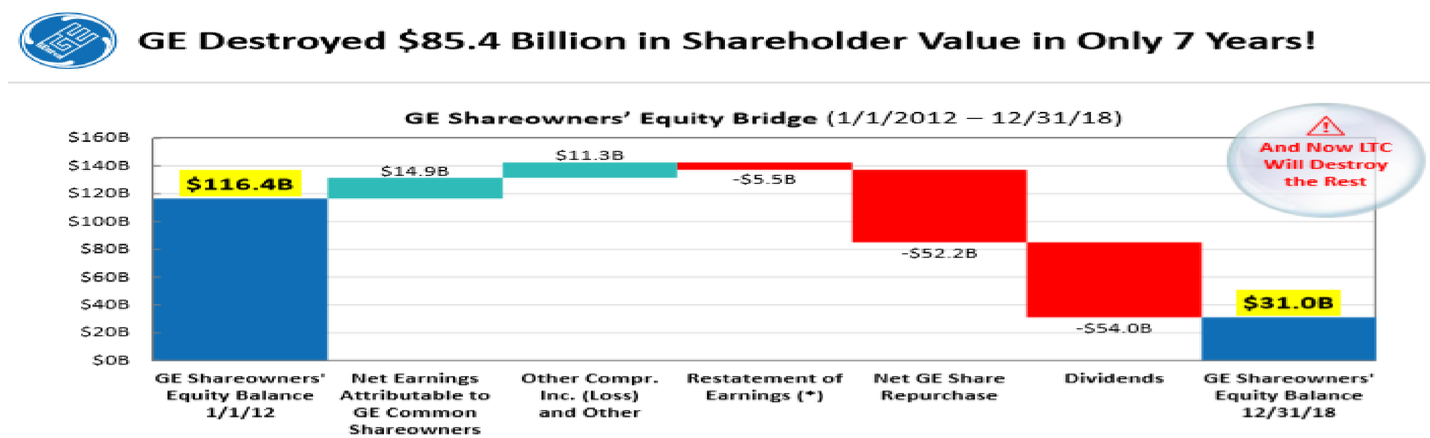


NB Comcast is rated A-

Triple-B cliff risk: hunting the wounded

- Highly-indebted behemoths beware!





Source: Markopolos report

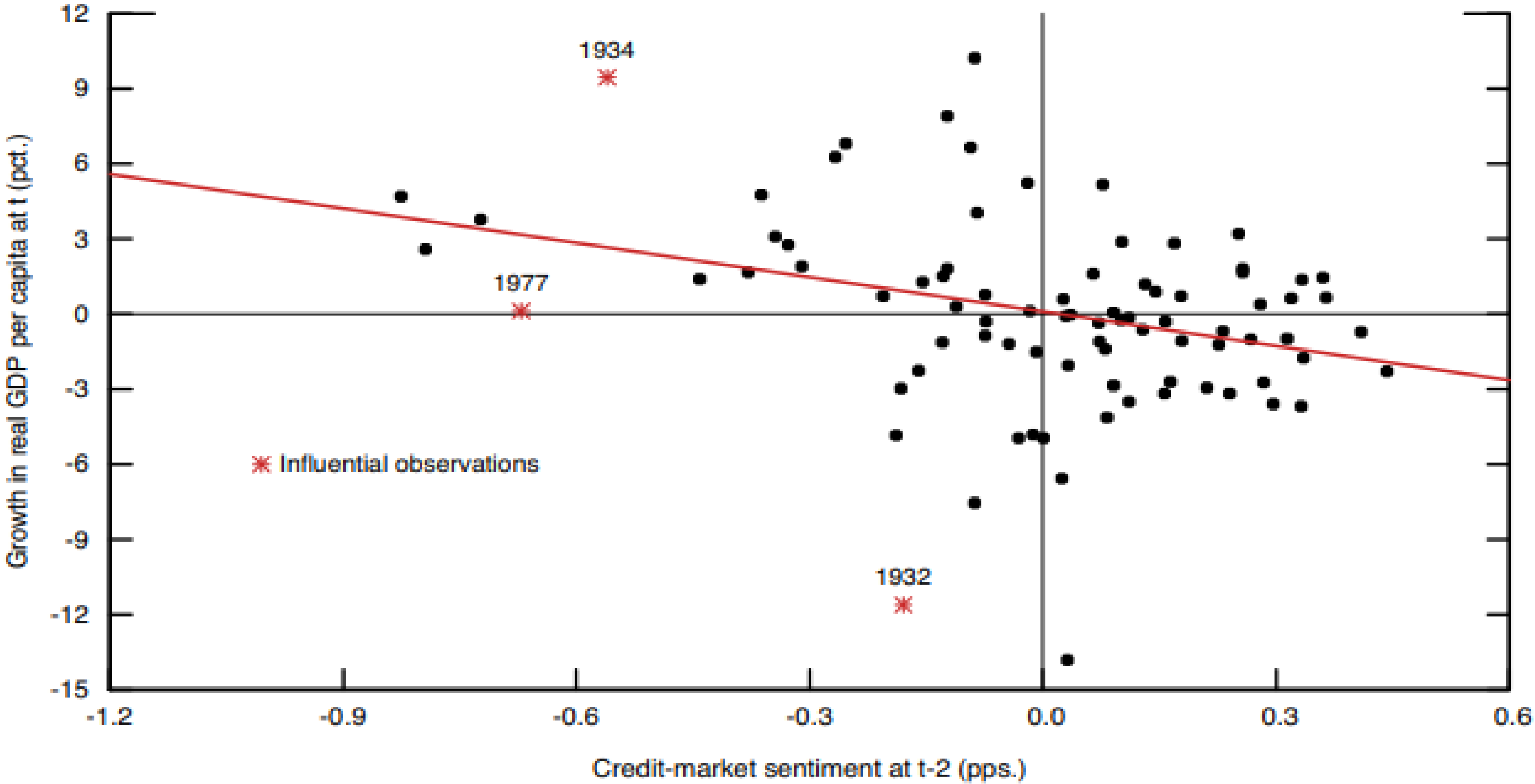
Credit spread widening presages economic downturns

- Credit spreads are an embodiment of the concept of the “external finance premium”
- This is the additional cost of finance demanded by external parties to compensate for their knowledge deficit relative to the management
- When credit conditions tighten, the premium rises in line with the uncertainty regarding the company’s financial performance
- Companies postpone purchases to conserve internal funds and minimise on the use of external finance

Credit spread widening reliably predicts a downturn

- Significant deleveraging in non-financial sector

Negative relationship between credit market sentiment and real GDP growth per capita



Source: López-Salido et al. (2016)

Conclusions

- The game is almost up for modern central banking
- Financial repression is losing its grip on credit spreads and credit conditions are tightening for a fat tail of unprofitable businesses
- CBs are no longer able to throw a cloak of protection over everyone
- As the weak go to the wall, economic capacity will be destroyed but demand will be bolstered by fiscal expansion; pricing power will remain
- Default cycle will be severe and prolonged, with profound economic and political consequences

Economic Perspectives – Partnership selections

Platinum Partner

Platinum partners are entitled to frequent onsite meetings or dedicated conference calls, all publications, research archive access, Research Insight presentations, seminar invitations and private lunches with our chief economist Dr Peter Warburton. Platinum partners are welcome to submit ad hoc requests and to suggest items for our research agenda.

Gold Partner

The gold partnership includes three onsite meetings or dedicated conference calls per year, with full access to our publications and our research archive. Gold partners are entitled to an additional Research Insight presentation each year, invitations to seminars and private lunches with Peter Warburton.

Silver Partner

Silver partnership is intended as a minimum level of engagement with our research agenda, but with the flexibility to add on some of the other elements of the service. The table shows the basic level of engagement but silver partners are encouraged to tailor the package to meet their requirements.

This more flexible arrangement will be provided with an agreed upfront cost with the option to upgrade to gold or platinum partner at a first-year discounted rate.

Bespoke Partner

Economic Perspectives has carried out numerous bespoke assignments for our research partners over the years, covering a wide spectrum of global macro topics and projects. We've tackled assignments on the US auto finance sector, the China over-investment thesis, the macro outlook for Canada and the impact of negative interest rates on European financial institutions.

We also write regular articles and essays on global macro and investment themes for the exclusive use of our Research Partners. If you would like to see a sample report, please get in touch.

Become a Research Partner with **Economic Perspectives** today.

Dr Peter Warburton

Peter@EconomicPerspectives.co.uk
+44 1582 696999
www.EconomicPerspectives.co.uk