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Rally in lower ranked US investment-grade bond market exposes new downturn risks

by [Alexander Engeln]

US markets are in fluctuation: heightened uncertainty in an equity market that is still recovering from a recent slump, and treasuries offering not enough yield for investors' tastes, have been a boon for the US bond market in 2019. Analysts at the Bank of America Merrill Lynch have predicted newly issued investment-grade bonds worth between USD 110bn and 130bn to enter the market in May alone, with the whole of 2019 being projected as having record high bond issuance not seen in years. In the week leading up to May 8, as much as USD 14bn have been pulled from US equities, while USD 7.3bn were freshly put into bonds in the eighteenth week of inflows, according to strategists at the same bank said. Overall, especially the broader US high-yield bond market has seen success in 2019 in the form of a YTD return of around 9% after a loss of 4.7% in Q4 2018.

But while some markets flourish, others flounder: uncertainties like the future of the US-China trade agreement, downwardly adjusted economic growth expectations and a dovish stance at the Federal Reserve have driven volatility on the equity market to higher levels and have left investors on the defensive. After a disastrous Q4 2018, overall its worst year since 2008, the S&P 500 seen in Figure 1a is only now catching up to its level in September 2018. This credit risk is also represented in the Aggregate (= Median) NUS-CRI 1-year Probability of Default (Agg. PD) for US-domiciled firms in Figure 1b, which at the end of 2018 had surpassed its highest levels since 2016 and currently remains elevated:

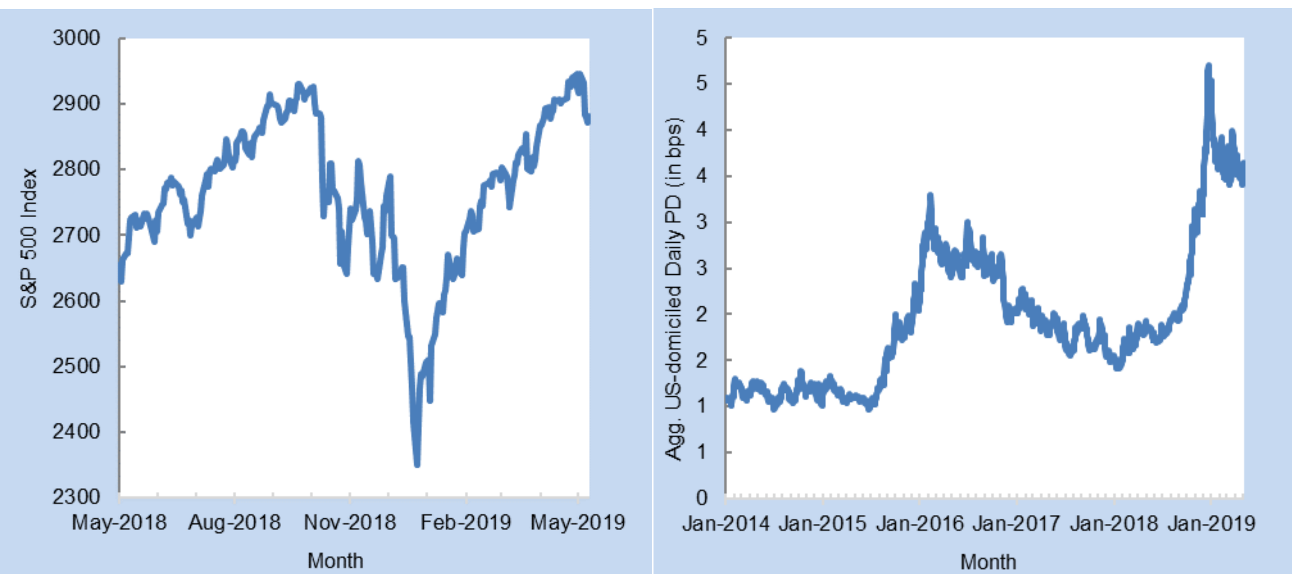

Figure 1a & 1b: S&P 500 Index since May 2018 (left) and Agg. PD for US-domiciled firms since May 2014 (right). *Source: Bloomberg (left), NUS-CRI (right)*

While economic uncertainty is a feature of markets, if it is perceived as too high by investors, they normally tend to flee towards safer treasury havens. But when the US offered USD 27bn in new 10-year notes on May 8, [it experienced the weakest demand since 2009 with a bid-to-cover ratio of just 2.17], perhaps due to the treasuries' multiple-year low yields. This could mean that investors' demand for low-risk, low-yield bonds is nearing its limits, despite their pessimistic economic outlook. This pessimism is not only seen in the pulling of funds from equity markets, it has also driven the US treasury yield curve into its second (though again short-lived) inversion in just two months on May 9, where the yield of the 10-year note was lower than that of the 3-month bill, which has historically been seen by some as an indicator of an upcoming recession. So for the moment, while the demand for low-yielding treasuries may have gone down in recent months, and equity investors are looking for alternative investment vehicles, corporate bonds promising higher yields benefit the most from the current circumstances.

However, as the demand for high-yield bonds has grown, so has the investors' risk profiles: a recent Quarterly Review report by the Bank for International Settlements (BIS) has indicated that today's increased investments in BBB and BBB- rated bonds could lead to significant market risks in the case of an economic downturn. In the last nine years, chasing after higher yields in a low-yield bond market, corporate bond mutual funds in the US have increased ratios of bonds with the lowest investment-grade rating to total bonds in their portfolios from around 17% in 2010 to nearly 46% in 2019. In doing so, they have exposed themselves to significant downturn risk, according to the BIS. Since many mutual and retirement funds are legally bound to only hold investment-grade bonds, a recession would not only increase the number of defaults of bond issuers, it would also lead to a number of rating downgrades, pushing some of the formerly BBB and BBB- rated bonds into junk-status. Due to the aforementioned minimum rating quality rules, this would in turn lead to a fire sale, in which funds would legally need to sell off these bonds as soon as possible, further exacerbating the market crisis and potentially limiting bond market liquidity.

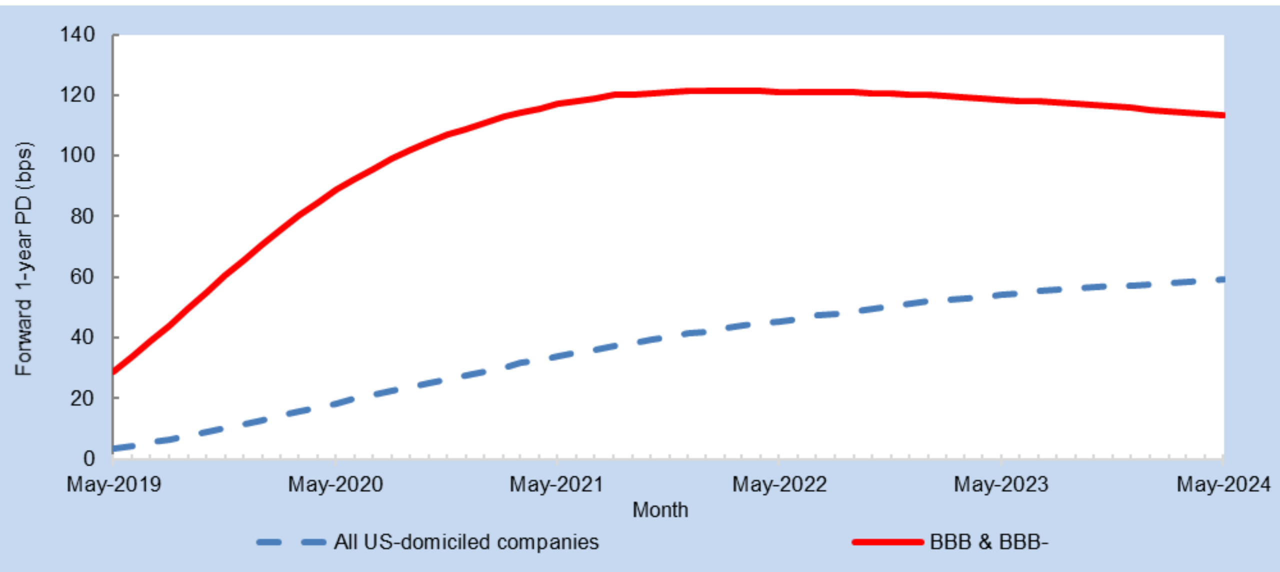

Figure 2: Agg. Forward 1-year PD term structure for BBB & BBB- grade and the entirety of US-domiciled firms. Ratings are based on the NUS-CRI Probability of Default Implied Rating (PDiR). The PDiR provides a more conventional interpretation of PDs – it translates NUS-CRI PDs to letter ratings by taking reference from the historical observed default rates of Standard & Poor's (S&P) rating categories. S*ource: NUS-CRI*

Whether the pessimistic outlook of investors will hold true and this type of risk actually has an impact on the market will be seen in the coming months and years. The data seems to support the investors' perceived risk of an upcoming economic downturn though, as it can also be seen in the Forward 1-year PD for BBB & BBB- rated US-domiciled firms, with the entirety of US-domiciled firms included as a benchmark. The Forward PD represents a computation of the median credit risk of all grouped companies in a future period, which can be interpreted similar to a forward interest rate (for example, the 7-month forward 1-year PD is the median probability of a group that a firm will default during the period from 7 months onwards to 1 year plus 7 months, conditional on the firm's survival in the next 7 months). As shown in Figure 2, the PD of the lowest investment-graded firms will rise significantly more quickly in the short- to mid-term than its benchmark. This is in line with the risk of fire sales caused by downgrades into junk territory, which higher graded firms are further away from. Although this does not necessarily imply an economic downturn, such an event could be a possible cause, which is in line with the current pessimistic view of investors.

Credit News

Russia ramps up bond sales ahead of possible US sanctions

May 9. Russia has tapped on international investors for billions of dollars of cash ahead of the US sanctions, which would affect the sovereign debt of the country. Already hit by the penalties imposed by the US, the finance ministry sold RBS 73bn in rouble-denominated bonds in order to raise RBS 600bn in domestic debt. Experts are of the opinion that their new US sanctions could damage Russia's bond markets and hence the limits on the amount of bonds offered at weekly auctions has been removed leading to a record bond sales thereby drawing the foreign investors. (FT)

Brexit delay rekindles allure of UK's junk bond market

May 9. The Brexit delay has reinforced the strong demand for good credits in sterling as the decline in the average yields on sterling junk bonds, an indication of borrowing costs, dropped from 8.1% to 6%. Recently, a number of companies have sold bonds in a large amount after the EU leaders agreed to postpone their divorce from the Britain. Companies like Virgin Media and Co-operative Group have each sold bonds and securities worth USD 390mn respectively. Meanwhile the sterling leveraged-loan market continues to struggle as companies move to loans denominated in other currencies such as USD and EUR. (Bloomberg)

China's sinking online lenders seek lifeline from big investors

May 8. The P2P platform was built to boost the financial inclusion as it help connect both small borrowers and the lenders. They gave lenders double-digit returns and added a new channel for the borrowers. The investors were lured to P2Ps by their high interest rates and plowed an average of USD 3370 into China platforms. This industry had more than USD 150bn of loans outstanding and upwards of 50mn investors at its peak. But the industry began to shrink due to the increasing news of fraud and defaults spread and subsequently, the number of platforms would decline by 70% this year. The larger players in the industry have started collaborating with large institutions and lenders have gradually replaced by institutional money managers and banks. (Bloomberg)

Interest-only commercial loans rise to pre-financial crisis level

May 8. Interest-only mortgages together with partial interest-only loans have accounted for 89% of the loans backing all new commercial mortgage-backed securities in the first year of 2019, the highest level since 2009. The surging number raises concerns on a return to crisis-era loose lending and a spike in defaults if there is an economic downtown. Lenders will face bigger losses on the unpaid principal if stretched borrowers start to default as the economy weakens. Combined with commercial property price drop, lenders' have to increase writedowns on their balance sheet as the collateral backing the loans also falls in value. (FT)

Fed warns leveraged lending could exacerbate a downturn

May 7. The Federal Reserve published a report warning about high levels of lending to highly indebted US companies. According to the report, a record of 40% of loans to highly indebted companies went to the most indebted ones. Corporate debt levels are also high and there is a very high appetite for risk in the market. If the economy encounters a downturn, a good deal of corporate distress could be expected. The resulting dismissal of workers and cutting down of investment spending could make the next recession a deeper recession. (FT)

US yield curve inverts for first time since March (FT)

Debt-laden Altice pays heavy price for new bond deal (FT)

Foreign investors raise China bond holdings as index inclusion begins (Reuters)

Regulatory Updates

China bank first-quarter bad loans hit 16-year-high as regulator tightens oversight

May 10. The amount of non-performing loans (NPLs) at China's banks rose to CNY 2.16tn at end March 2019, the highest since end 2003. To potentially fend off systemic financial risks, the authorities also drafted new rules to require lenders to recognize bad loans, defaulted bonds, souring interbank assets and off-balance sheet businesses as non-performing assets and require lenders to set aside more capital as buffer. Banks are also required to classify loans that are more than 90 days overdue as NPLs. Lenders have beefed up their capital strength in January-March to 14.18%, 0.57% higher than one year ago. (Reuters)

IMF warns of vulnerabilities in Ireland's nonbank financial sector

May 10. The IMF raised warning on Ireland's nonbank financial sector due to its large scale and rapid growth as vulnerabilities in the sector comprising of investment funds, money market funds and other financial intermediaries are emerging. This is due to the use of leverage by investment funds and the sector receives most of its funding from abroad and invests mainly in foreign assets. Although the sector has made preparations for Brexit, the growth of nonbank sector is also expanding the size of the financial sector, bigger than pre-crisis levels and a no-deal UK crash will have a significant and immediate impact on the Irish economy. The links of the nonbank financial sector to the domestic economy is also growing. (FT)

EU banks call for rethink of capital markets project (Business Times)

New Zealand cuts interest rates to historic low (Bloomberg)

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