FINANCIAL REVIEW

Opinion

Global bond markets have turned topsy-turvy

Rather than punish the profligate and push borrowing costs up, the scale of investor demand for income sources has easily absorbed the corporate debt deluge.

Michael Mackenzie

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Those with long memories of the credit woes that typified recessions since the early 1990s are living in a topsy-turvy world, thanks to the dramatic actions of central banks in March.

A highly uncertain future for the economy and companies should prompt risk aversion among investors in the world of credit, whereby low prices and higher yields prevail for some time. Instead, credit markets are now telling a very different story.

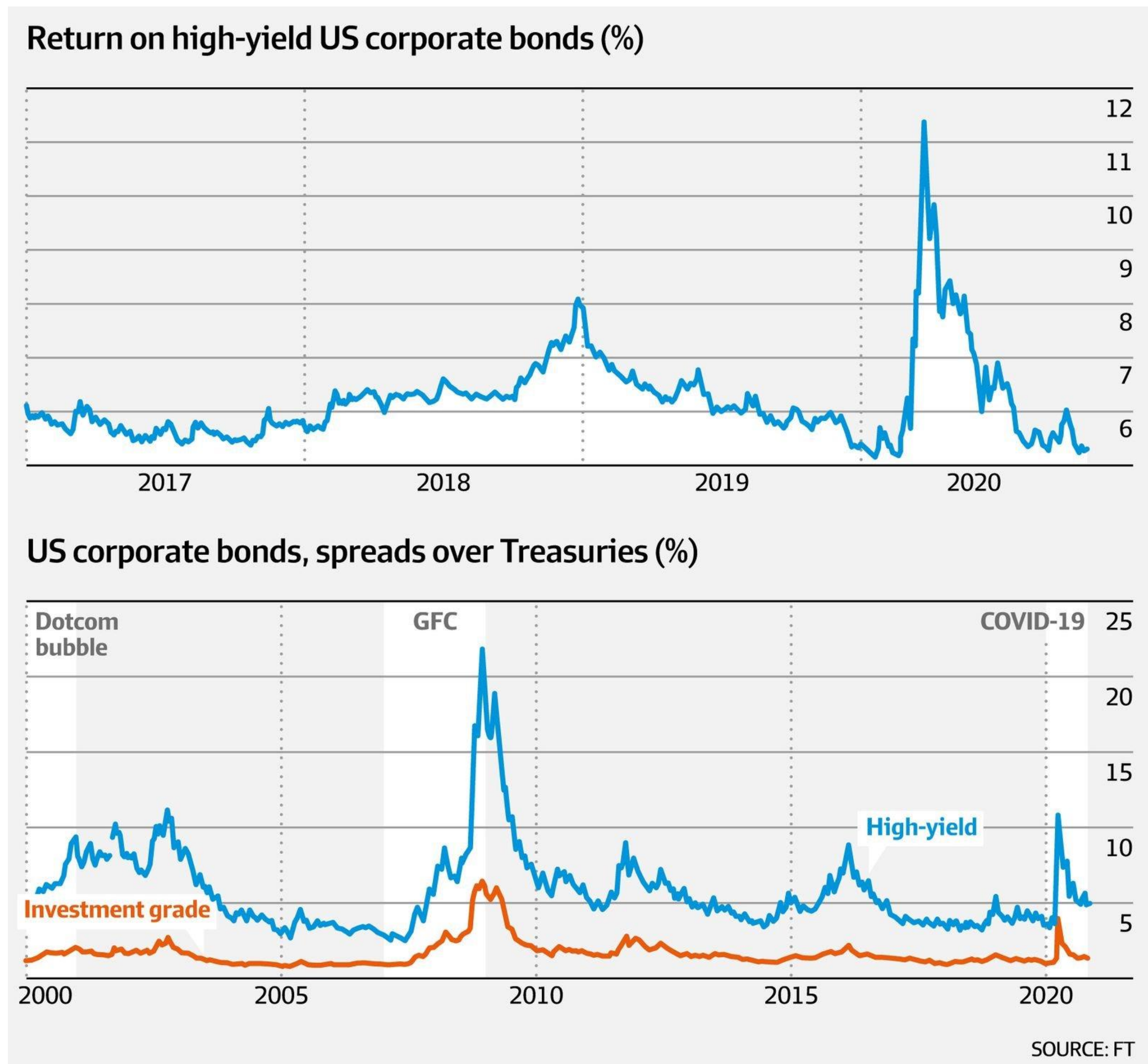
The Federal Reserve in Washington. Central banks are not shy about reminding us that investors are operating in a world where the normal rules do not apply. **AP**

An important measure of how investors view the debt of companies comes from comparing their usually higher borrowing costs with those of the US government. This gap has narrowed sharply from March levels for US investment-grade and high-yield debt and it is not far from the pre-pandemic levels of February.

“Everything has been turned on its head,” observed Matt King, global head of credit strategy at Citigroup. Rather than focus on fundamentals, investors “spend their time looking at central bank liquidity” and the level of inflation-adjusted Treasury yields for guidance.

What really underlines the upside-down world in credit is how current conditions have occurred at a time when companies are borrowing record amounts of new debt this year.
Sales of investment-grade and high-yield corporate debt are running 70 per cent above the pace seen in 2019 at $US1.943 trillion ($2.7 trillion) at the end of September according to Sifma, a trade association for financial markets.

Rather than punish the profligate and push borrowing costs higher, the scale of demand from investors for sources of income has easily absorbed the corporate debt deluge. Even with a rising tide of defaults, benchmark yields for speculative rated companies have recovered impressively from a peak of 11.4 per cent during March market stresses towards a more comforting 5.2 per cent, according to Ice Data Services.



One can hardly fault the logic of investors when central banks are backstopping credit markets and encouraging the buying of risky assets. With government bonds yielding less than zero across Europe and below 1 per cent for a US 10-year Treasury note, some argue that owning high-quality corporate debt ticks the boxes for being a "safe" asset while offering a more attractive fixed rate of interest.

Central banks are not shy about reminding us that investors are operating in a world where the normal rules do not apply. Last week, an official at the Federal Reserve Bank of New York discussed the various credit market facilities launched in March and indicated there was a willingness to step up purchases of corporate bonds "if market functioning measures indicate deterioration".

Some argue that the current level of credit spreads signals that the worst is behind us. However, such a conclusion must be weighed against the distortions arising from central bank market forces. During the past two default cycles that marked

the early 2000s and the global financial crisis, the all-clear signal took a lot longer to arrive.

Mark Dowding, chief investment officer at BlueBay Asset Management, argued that central banks were “deferring or elongating the period over which defaults arise” and “we are not out of the woods yet”.

Fitch Ratings forecasts a cumulative default rate for US high-yield bonds over the next three years of between 15 per cent and 18 per cent, not far from the pace of 22 per cent seen from 2008 to 2010. That provides scope for distressed debt funds and rescue finance teams to find selective restructuring opportunities in areas hit hard by pandemic restrictions, such as commercial real estate, hospitality, travel and retail.

However, in another break from the past, returns among private debt funds may fall short of current high expectations. A record amount of money chasing distressed and restructuring opportunities may well push up prices and reduce the scale of future returns.

That still looks better than the outcome for traditional credit investors given the prevailing low level of corporate bond yields and narrow risk premiums. And the credit market retains plenty of companies with hefty levels of leverage, even among those with investment-grade ratings.

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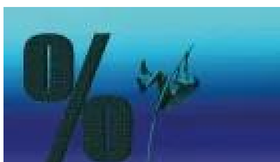

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Columbia Threadneedle Investments estimates that among the non-financial investment-grade companies they cover globally, they expect net debt in the US to exceed two times earnings before interest, tax, depreciation and amortisation by the year-end. That would represent a steady increase from 1.16 times in 2009. For Europe, the fund manager forecasts it to be 3.1 times by the end of the year, up from 2.5 times in 2009.

The bill for this year’s debt binge beckons once the pandemic abates. It can only hold back an economic revival when companies focus on cost-cutting at the

expense of investing and hiring staff.

That leaves credit markets sitting on far more expensive values than what is warranted by the economic realities of high debt and modest growth prospects.

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