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The Corporate Bond Market: The Start of the Matter

Of all virtues to which we must ultimately aspire, forgiveness demands the most of our souls. In our naivety, we may fancy ourselves man or woman enough to absolve those who have wronged us. But far too often, we find our pool of grace has run dry. So deeply burdened are we by our emotions that grace to us is lost. How many of us have the strength of resolve to let bygones be gone for good? Those of the cloth recognize the damage self-inflicted scars sear into our souls as they seek to guide us through life's most difficult journeys. They pray for our deliverance from a painful inner turmoil and with it the peace only forgiveness can convey.

None who have ever heard Don Henley's The Heart of the Matter could be blamed for thinking divine inspiration itself came down from the heavens to spawn those longing lyrics. But it isn't just the words that scorch their way into your memory, it's Henley's tone, the raw pain that pierces every time you're caught off guard by the mournful ballad released in 1989. Henley sings of our feeble struggle as no other, grasping for our collective release in humility. "The more I know, the less I understand. All the things I thought I'd figured out, I have to

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learn again." In the end, Henley hands down the cruelest of convictions: If you truly want to vanquish your demons, you must find the strength within to forgive.

Astute policymakers might be saying a few prayers of their own on fixed income investors' behalves. The explosion in corporate bond issuance since credit markets unfroze in the aftermath of the financial crisis is nothing short of epic. Some issuers have been emboldened by the cheap cost of credit associated with their sturdy credit ratings. Those with less than stellar credit have been prodded by equally emboldened investors gasping for yield as they would an oasis in a desert. Forgiveness, it would seem, will be required of bond holders, possibly sooner than most of us imagine.

For whatever reason, we remain in a world acutely focused on credit ratings. It's as if the mortgage market never ballooned to massive proportions and imploded under its own weight. In eerie echoes of the subprime mania, investors indulge on the comfort food of pristine credit ratings despite what's staring them in the face – a credit market that's become so obese as to threaten its own cardiac moment. It may take you by surprise, but the U.S. corporate bond market has more than doubled in the space of eight years. Consider that at year end 2008, high yield and investment grade bonds plus leveraged loans equaled $3.5 trillion. Today we're staring down the barrel of an $8.1 trillion market.
The age-old question is, and remains: Does size matter?

Ask yourself, did size matter as it pertained to the mortgage market way back in 2006, when it peaked in size at $13 trillion? (That was rhetorical in the event you weren't on Planet Earth at the advent of all modern times' meltdowns.) Still, it's the **why** behind the growth of any given market that matters most. In the case of both markets, the credit rating agencies have helped investors sleep at night, a fact that might now keep you up at night.
First, a disclaimer. Of course, speculative grade debt is riskier than its investment grade brethren. The vast majority of investors in the go-go junk market know this and are hopefully buckled up as such, especially if a true rate-hiking cycle is about to test their mettle – more on this later.

Still, it's the blind abandon with which issuance has risen among investment grade (IG) issuers that should, but has yet to, give supposedly conservative investors pause. Consider that in 2011, a (then) record $741 billion was sold into the IG market. As an endless encore, in every single year that followed, issuance has shattered the prior 12-month record. Last year alone witnessed $1.28 trillion in issuance. As for all the rate hike anxiety permeating the airwaves, 2017 also appears to be in it to win it — $254 billion was sold in the first two months of the year, $20 billion more than the same period in 2016. Investors might soon have to call upon Archimedes' concept of exponentiation to sufficiently capture how very large the numbers have become.

You might wonder how the health of the corporate bond market is faring as it bulks up. As Bloomberg reported last week, you'd have to time travel back to 2002 to get back to the last time IG issuers were carrying more debt vis-à-vis their profits. The sticking point is leverage ratios tend to peak as an economy is just emerging from recession, as companies' revenue streams hit their nadir.

Today, though, as we've been told in tsk-tsk fashion, the economy is at the precipice of an accelerating trend. That's a good thing as companies have sold a heck of a lot more debt than their profit growth justifies, leaving their rainy-day cash to cover their massive, mounting obligations at the lowest levels since 2009.

The good news is that on the surface, the chances of a hiccup appear to have diminished. According to credit rating agency Standard & Poor's (S&P), 2016 ended on a relatively better low note: Some 68 global IG issuers were at risk of being downgraded speculative grade, five fewer than the last time the data were compiled at the end of the third quarter.

S&P refers to these envelope-pushing issuers as 'potential fallen angels,' with ratings at the cusp of crossing over into junk-land. Though you might be thinking one notch on a ratings scale is just that – one measly notch – crossing that line in the sand makes a huge difference for borrowing costs. The yield 'spread' above Treasuries paid by junk issuers is typically about double that of what IG issuers pay.

The not so good news is that the universe of potential fallen angels remains at historically high levels. The latest read of 68 potential fallen angels is identical to what it was last summer and appreciably higher than as recently as 2015's first quarter when 42 issuers were at risk of downgrade to spec grade. Moreover, the divide that began to open between potential rising stars – those with the potential to be upgraded into the IG sphere – and potential fallen angels remains at the current cycle's wides.

Perhaps most worrisome is the sector at the greatest risk of downgrades — that is, financials. Years ago, a high yield strategist remarked that declining commodities prices would take their toll in two waves – first, the actual commodities producers, and second, the financials who banked them as the initial commodities cycle became super-sized in magnitude. Bank balance sheets are highly susceptible to a nasty contagion effect.

And yet, here we sit watching those oil prices Janet Yellen lectured us would be at 'transitory' lows (several years ago) decline anew. God help us if crude's latest swoon presages a broader downturn. Precisely **because** leverage is rising among IG borrowers, economic growth literally **has** to hang in there. If growth even slows, or worse, contracts, all this ballyhooed record issuance among IG issuers will devolve into unprecedented levels of potential-to-actual fallen angels. It will be as if the heavens have opened up as their wings burn and they tumble back to earth.

Of course, downgrades don't necessarily denote defaults. The Start of the Matter may nevertheless require forgiveness in some form as refinancing needs are also now at record levels and must be met. If the Federal Reserve does not intervene, markets are likely to revert back to pure price discovery mechanisms; they will be brutally agnostic to the rate environment to say nothing of the economic backdrop.

Investors have begun to smell a rat. IG exchange-traded funds (ETFs) have slid more in price compared to their high yield ETF peers since the surprise U.S. election that set rates rising. But unlike junk's magnificent rebound since then, IG has yet to stage a return rebound.

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It all comes down to refinancing risk. According to S&P's competition down the block, Moody's, the refinancing needs of both IG and spec grade issuers will hit record levels over the next five years.

Spec grade issuers' five-years-out refinancing needs have officially crossed the trillion-dollar threshold. Some $1.06 trillion will come due between now and 2021, up from $947 billion in last year's refinancing risk study and double what they were ten years ago. In the event you're concerned spec risk has been overly downplayed in this missive, rest assured, the same dynamics that propel record fallen angel levels will be the mother of all default-rate cycle accelerants. File that one away in the 'actual forgiveness' to come file.

As for the IG space, $944 billion comes due in the five years through 2021. But here's the kicker – the need to roll over debt is going to come on much more quickly for IG. Maturities are roughly evenly distributed over the next five years as opposed to the needs in spec grade, whose rollover risk gains speed and crescendos in 2021 with a record $402 billion in refinancing coming due.

Is that why junk is trading more richly than IG? The yield at which spec trades vs. its Treasury equivalent has only been wider 13 percent of the time over the past 17 years (2007 should provide you comfort because…?). IG on the other hand has traded this 'tightly' in only 25 percent of the times records have been kept.

Would the start of the matter – the prospects for debt forgiveness and debilitating defaults – be threatening so were it not for central bankers' meddling ways in markets designed to determine their own damn prices? The ashes will indeed scatter. They will let us know.

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