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Corporate bond market hit by rates fears

Robin Wigglesworth and Eric Platt in New York

Investor alarm at the riskier end of the US corporate bond market is mounting, with borrowing costs for the lowest-rated companies climbing to their highest level since the financial crisis as the Federal Reserve prepares to raise interest rates for the first time in nearly a decade.

While the US stock market has recovered after a bumpy autumn and is relaxed about the prospect of tighter monetary policy, the corporate bond market has become increasingly jittery. Typically, when bond and stock markets point in different directions, a drop in the former augurs a correction in the latter — as happened this summer.

Concerns over the possible impact of a US interest rate increase on more vulnerable borrowers has been exacerbated by rising indebtedness and shrinking revenues among companies. This has fuelled concerns that the profitable "credit cycle" that has reigned since the financial crisis receded is coming to an end.

"People are going to be carried out on stretchers," said Laird Landmann, a senior bond fund manager at TCW, a Californian asset manager. "When earnings are coming down, leverage is high and interest rates are going up. It's not good."

Safer corporate bonds judged "investment grade" by Standard & Poor's, Moody's or Fitch have been reasonably steady, with average yields dipping slightly again after a faltering start to November. But debt rated below that threshold has had a bad autumn, particularly debt issued by companies in the struggling energy industry.

UBS estimated in a note last week that as much as $1tn of US corporate bonds and loans rated below investment grade could be in the danger zone as borrowing conditions become tougher just as many face repayments. Much of the pain is in the energy sector but the Swiss bank argues the problems are wider than this.

"It is our humble belief that the consensus at the Fed does not fully understand the magnitude of the problems in corporate credit markets and the unintended consequences of their policy actions," wrote Matthew Mish, a UBS strategist.

The bottom of the corporate bond food chain suffered an especially savage period. The price of US company debts rated "CCC", one of the lowest rating agency rungs, has slid to the lowest since 2013, according to Bank of America Merrill Lynch indices, catapulting the average yields to a six-year high of 16.69 per cent.

The default of Swift Energy last week brought the number of global defaults to 102 for this year, the highest since 2009. Of those, 63 borrowers were in the US, according to Standard & Poor's. In all of last year only 60 companies defaulted, and analysts expect the default rate to tick up in 2016.

Moody's said last week that the number of companies on its "distressed" list — rated B3 or below with a negative outlook — rose by 5 per cent in November to 239. That is a 37 per cent jump year over year.

The credit worries have started to manifest themselves in investor flows. While flows into junk bond funds remain positive for the year, managers of both exchange traded funds and mutual funds have been hit by outflows of roughly $3.3bn over the past four weeks, according to data from Lipper.

In the wake of a stellar October, State Street's high-yield bond ETF — known by its stock market ticker JNK — has suffered outflows of $773m over the past four weeks. BlackRock's popular junk ETF, known as HYG, has seen withdrawals of roughly $76m over the same period.