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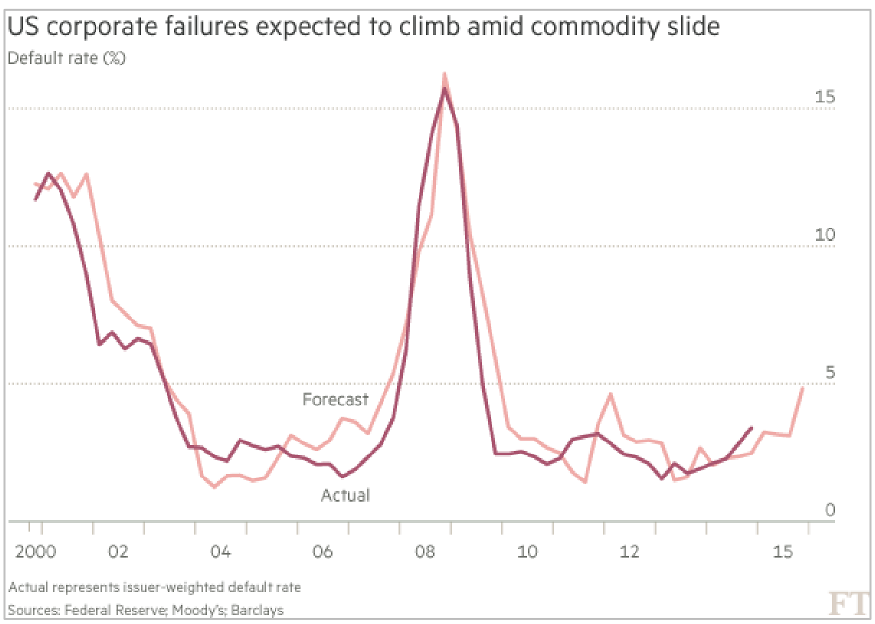
Markets Outlook 2016: Credit homework pivotal for investors

By Eric Platt and Gavin Jackson

More than ever, undertaking credit homework matters for corporate bond investors.

After years of relative tranquility, credit investors have been jolted by sudden and often unexpected volatility over the past 11 months.

Sliding commodity prices have duly punished highly indebted US oil and gas drillers. The emission scandal at Volkswagen and persistent concerns over drugmaker Valeant's business model have reverberated through credit markets. Bonds issued by US retail, media and pharmaceutical companies have suffered of late, making it more expensive for companies to roll over their debts or sell new bonds.



As a new year beckons, the risk of more credit shocks looms for the US market. A steady rise in corporate bond yields since April has reflected investor concern over record sales of debt, falling revenues and profits for companies along with the prospect of the US Federal Reserve raising borrowing costs.

In contrast, investors in Europe expect a smoother ride as the European Central Bank continues suppressing borrowing costs in an effort at fostering a recovery in the broad economy.

Mike Scott, credit portfolio manager at Schroders Investment Management says the US credit cycle has entered its latter stages, while Europe is experiencing ''a more benign environment ... of relatively low growth and low inflation''.

In the broad US credit space, bankers and portfolio managers warn that the recent aversion to lower-rated junk paper will continue, with many watching how far the Fed tightens policy during 2016.

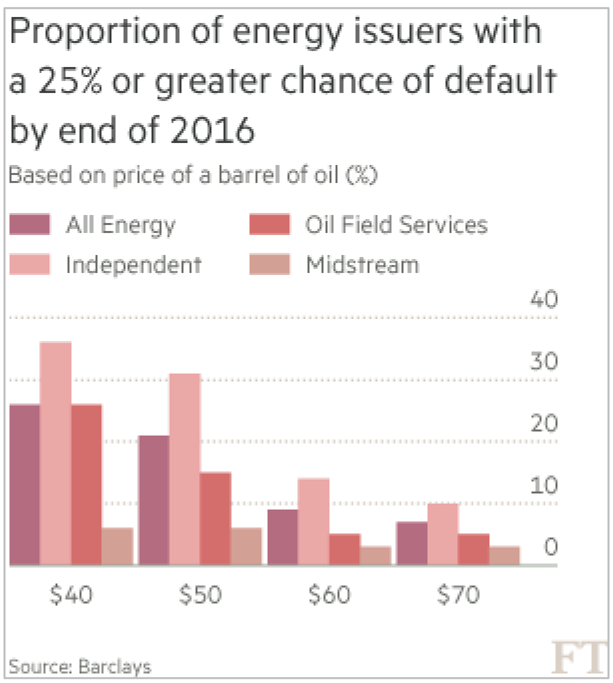
While higher bond yields may herald a buying opportunity for investors during 2016, particularly should the US economy accelerate, there are legitimate concerns. Some investors are alarmed at rising levels of leverage for investment grade rated companies like Microsoft, Halliburton, Coca-Cola, UnitedHealth and AT&T who have sold debt to fund dividends, stock buybacks and multibillion dollar acquisitions.

"It should be an environment where active investors — credit pickers — should get more rewards for making the right credit calls,'' says David Riley, head of credit strategy at BlueBay Asset Management. ''And you will continue to be severely punished if you step on a landmine in credit."

Fear that the credit cycle may have turned is illustrated by more than 100 company defaults so far this year, the highest figure in six years. For 2016, strategists expect defaults to trend higher against a backdrop of lacklustre global growth.

Reticence among investors is in part already baked into bond prices, with average option adjusted spreads on the Barclays US high yield index up more than 120 basis points from the year's start in comparison to benchmark Treasury yields.

Large US mergers and acquisitions are expected to tap investors for financing, however investors have become increasingly discerning. A few recent debt offerings to fund leveraged buyouts of junk-rated groups have been sold or shopped at a discount, including deals from apparel maker Fullbeauty, generic drug manufacturer Lannett and data-storage group Veritas, which saw its offering ultimately postponed.



As 2016 beckons, risk averse portfolio managers have crowded into improving credits, buying bonds of double-B rated groups — the top tier of the high-yield credit pile — and avoiding companies seen at risk of downgrade, particularly as liquidity deteriorates.

Strategists with UBS say that the risk of contagion in the US high-yield space has climbed as commodity prices hover near multiyear lows, with analysts at Moody's and Standard & Poor's projecting a rise in defaults over the next 12 months as smaller shale producers go out of business.

The US faces far greater exposure to lower oil prices than Europe or Asia, as more than a tenth of the junk market in the States is made up of debt issued by energy companies.

"Where we don't think you'll see a dramatic pickup in defaults, you could very well continue to see a downward migration in ratings ... given the willingness of companies to borrow to buy back stock and the event driven one offs," says Brian Kennedy, a portfolio manager with Loomis Sayles.

Meanwhile, the divergence in transatlantic credit and monetary cycles suggests the so-called reverse Yankee trend of US companies selling eurobonds is unlikely to abate.

During 2015, US-based companies have been the biggest issuers of euro-denominated corporate bonds by nationality, tempted by the low interest rates on offer and the possibility of swapping the proceeds back into dollars, accounting for 21 per cent of the European market.

“You will continue to see the US maintain a solid, call it, 20-25 per cent of the market over here,” says Rupert Lewis, head of European syndicate at BNP Paribas. But with the cost companies pay to swap euros into dollars having risen, supply is likely to come from US companies with euro revenues — a ‘natural hedge’.

The big question for investors is whether global growth will be enough to keep the credit cycle from turning, as the high-yield market traditionally underperforms as defaults rise, according to Credit Suisse.

“The investor base is eager for the year to end. They are not being rewarded for putting on risk,” says Richard Zogheb, co-head of capital markets origination in the Americas for Citi.