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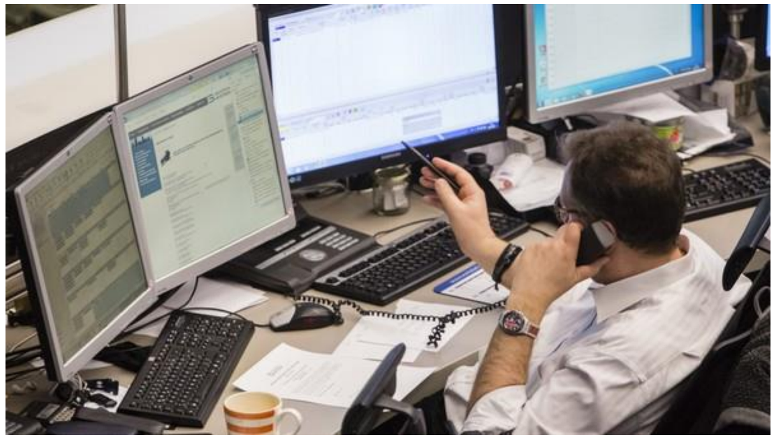
Corporate debt downgrades reach $1tn

Eric Platt in New York



More than $1tn in US corporate debt has been downgraded this year as defaults climb to post-crisis highs, underlining investor fears that the credit cycle has entered its final innings.

The figures, which will be lifted by downgrades on Wednesday evening that stripped four of the largest US banks of coveted A level ratings, have unnerved credit investors already skittish from a pop in volatility and sharp swings in bond prices.

Analysts with Standard & Poor's, Moody's and Fitch expect default rates to increase over the next 12 months, an inopportune time for Federal Reserve policymakers, who are expected to begin to tighten monetary policy in the coming weeks.

S&P has cut its ratings on US bonds worth $1.04tn in the first 11 months of the year, a 72 per cent jump from the entirety of 2014. In contrast, upgrades have fallen to less than half a billion dollars, more than a third below last year's total.

The New York-based rating agency has more than 300 US companies on review for downgrade, twice the number of groups its analysts have identified for potential upgrade.

"The credit cycle is long in the tooth by any standardised measure," Bonnie Baha, head of global developed credit at DoubleLine Capital, which manages $80bn, said. "The Fed's quantitative easing programme helped to defer a default cycle and with the Fed poised to increase rates, that may be about to change."

Much of the decline in fundamentals has been linked to the significant slide in commodity prices, with failures in the energy and metals and mining industries making up a material part of the defaults recorded thus far, Diane Vazza, an analyst with S&P, said.

"Those companies have been hit hard and will continue to be hit hard," Ms Vazza noted. "Oil and gas is a third of distressed credits, that's going to continue to be weak."

Some 102 companies have defaulted since the year's start, including 63 in the US. Only three companies in the country have retained a coveted triple A rating: ExxonMobil, Johnson & Johnson and Microsoft, with the oil major on review for possible downgrade.

Portfolio managers and credit desks have already begun to push back at offerings seen as too risky as they continue a flight to quality. Bankers have had to offer steep discounts on several junk bond deals to fill order books, and some were caught off guard when Vodafone, the investment grade UK telecoms group, had to pull a debt sale after investors demanded greater protections.

Bond prices, in turn, have slid. The yield on the Merrill Lynch high-yield US bond index, which moves inversely to its price, has shifted back up above 8 per cent. For the lowest rung triple-C and lower rated groups, yields have hit their highest levels in six years.

A large portion of the lowest quality debt issuers will face "severe refinancing challenges" by 2018 as cash flow generation remains weak, Matthew Mish, a credit strategist with UBS, noted.

"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," Mr Mish said. "The implication is that their actions will be reactive, not proactive — but only time will tell."