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US credit cycle has already turned; defaults to rise

The vast bulk of investors believe the US credit cycle has turned, new survey finds

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by: **Eric Platt** in New York

The vast majority of investors believe the US credit cycle has already turned with a spate of defaults from the riskiest borrowers expected.

More than 80 per cent of investors expect the default rate on junk-rated companies will top 5 per cent by the end of the year, up from the current 3 per cent, as US economic growth plateaus, according to a new survey of asset managers, insurance companies and pension funds by rating agency Fitch.

Almost 90 per cent of investors believe the current credit cycle is over.

While the Federal Reserve is chartering a cautious course as officials debatetightening monetary policy, investors believe lending conditions will tighten over the next 12 months.

The survey also underscores investors' unease with the recent relief rally in the junk bond market, in which spreads have compressed and returns on high-yield debt are near 4 per cent for the year. That outpaces the total return of the S&P 500.

Stephen Caprio, a credit strategist with UBS, characterised the recent rally as "tenuous".

"Structurally nothing has changed. Leverage is rising, lending standards are tightening, new high yield issuance is anaemic and oil prices are the big wild card," he said.

Three dozen companies have already defaulted this year, including Linn Energy, Peabody Energy and SFX Entertainment. The number of companies to miss a payment or complete a distressed exchange in the first quarter ran at a 44 per cent faster pace than in same period a year ago.

Fears that the high-yield market may freeze again if volatility rises has injected fresh urgency for lowly-rated corporate borrowers.

Energy companies, which accounted for nearly a third of the defaults in the first three months of the year, have slashed dividends and capital expenditure plans.

That trend will continue, the survey found, with investors expecting companies to sharpen their focus on paying off debts and conserving cash.

Despite a broad consensus that spreads — the difference between US government bond yields and that offered on debt sold by junk-rated companies — will widen high-yield bonds remain investors second favourite asset class after investment grade debt, the survey found.

The growing number of debt with negative yields in Europe and Asia is increasing the appeal of the asset class, fund managers say.

David Rolley, co-head of global fixed-income at Loomis Sayles, described the central bank action as a possible "longevity extender" of the credit cycle, cutting the rates corporate borrowers must pay to borrow.

"Every time the European Central Bank buys $10bn of corporate [bonds], pension managers in Europe and in the UK will have a hole to fill," he said. "Never say a central bank is out of bullets when their goal is to boost liquidity."

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