

[About sponsorship](#)**Corporate bond markets****A whiff of fear**

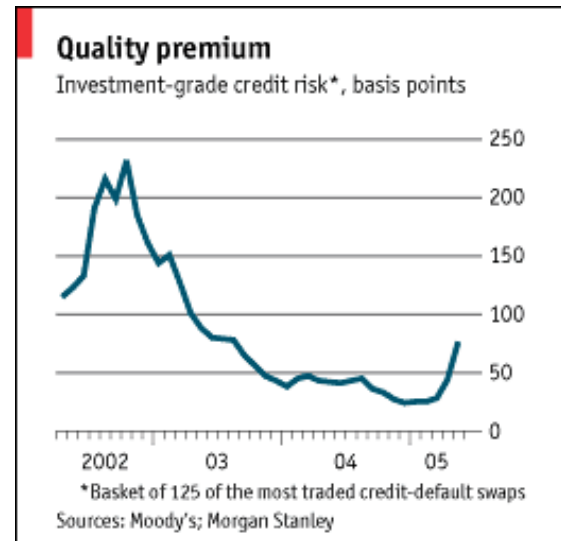
May 12th 2005 | NEW YORK

From The Economist print edition

After several bold years, the credit markets begin to tremble

BY MANY measures, America's economy continues in strikingly good health. Profits, already setting records, are up. Companies are swollen with cash and are hiring workers. The proportion of corporate bonds in default is the lowest since 1997. And GDP growth of 3.6% in the past year would be celebrated in France and Germany with lashings of champagne and *Sekt*. The Federal Reserve's eight increases in official short-term interest rates since June can be read as a response to the economy's strength.

Ah, but other interest rates—those paid on American companies' bonds—are rising too, and for a more worrying reason: credit quality. The most obvious instances of this have been the bonds of two giant carmakers, General Motors and Ford, which Standard & Poor's (S&P), a rating agency, downgraded to junk status on May 5th. However, the malaise in the market for corporate debt goes far wider than these two big names.



In retrospect, the price of credit-default swaps—in essence, insurance against companies' defaulting on their bonds—appears to have bottomed out in December. It rose noticeably in March and accelerated further this week (see chart). It is now back to where it was in the summer of 2003, when an American economic recovery was still in doubt. If rumours are to be believed, the latest move may have come about because hedge funds that have invested in these newfangled instruments may be in trouble themselves (see [article](#)).

As well as the price of default swaps, the spreads between the yields on risky and less risky bonds have begun to increase too. Having spent three years being extraordinarily brave (or foolish) in lending to companies and other risky borrowers at ever-lower prices, investors are once again demanding higher returns for greater risks.

American companies benefited greatly from the loosening of monetary policy begun by the Fed in late 2000. Between then and 2004, the Fed cut rates from 6.5% to 1%, before starting to tighten last year. The yield on ten-year Treasuries is even now less than 4.3%. Companies began to gain from cheaper money only after October 2002, when the spread between high-yield corporate bonds and Treasuries began to fall—from ten percentage points then to less than three in February this year, according to Moody's, a rating agency. The spread is now four points, and may widen more. Several planned bond issues have been postponed because investors are becoming more demanding.

Plenty of companies besides GM and Ford have been marked down. The swap price has increased for American International Group (AIG), a giant insurer mired in regulatory goo. Also affected have been TXU, a Texan utility; Clear Channel Communications, a radio broadcaster; Weyerhaeuser, a paper producer; and any retailer whispered to be considering, oh, almost anything—a stock buy-back, a leveraged buy-out, or an acquisition—such as J.C. Penney and Limited Brands. More speculative issues have been hit even harder. The prices of sovereign debt issued by Argentina, Brazil and Mexico have all slid. The market is also nervously watching Calpine, a utility with \$18 billion in debt. S&P downgraded its bonds, already rated as junk, still further on May 9th.

Last month two deals that would have gone through effortlessly in February sputtered to a conclusion. The first involved New Page, a company created by Cerberus, a private-equity house, in a buy-out of the coated-paper business of MeadWestvaco, a paper and packaging firm. Almost the entire \$2.3 billion price was to be financed in the public debt markets. During the roadshow for the deal, the suggested pricing for the mid-tier tranche of debt was 9.5%. In the event, it was priced at 10.25%, and then traded down in the market to 10.5%, according to S&P's Leveraged Commentary & Data (LCD), a non-ratings unit that reports on the loan and high-yield bond markets.

In the second deal, Carlyle Group, another private-equity firm, raised funds for its acquisition of Verizon's Hawaiian telecommunication business. The result was similar. At the last moment, the rate paid on the debt was increased and the size of the issue was reduced from \$550m to \$500m. Such reductions in size and increases in rates are becoming increasingly common, says Matthew Fuller of S&P's LCD; in other deals, he adds, the term of the bond has also been cut.

Some deals are not getting done at all. On May 10th, a bond issue for American General, an insurer, was announced and not completed. Although it is not surprising that the company, as a subsidiary of AIG, would encounter turbulence, such deals are not usually publicised until some sort of agreement on pricing has been reached. In the past four weeks, about \$1.3 billion of high-yield debt has been raised, compared with an average of \$2.5 billion every four weeks last year. Most of the newer issues are small, says Mr Fuller, ranging from a not very well-known oil-exploration firm to a manufacturer of industrial pumps.

If this is worrying for companies, it is worse for private-equity firms and investment banks, which have spent the past five years feasting on ever-cheaper credit. Often, companies were taken private with debt raised at one price and then refinanced more cheaply within months, and the financiers pocketed the difference. Now, just as the number of firms wanting to do deals has risen, the cost of bankrolling them has gone up as well. It is hard to believe that the remarkable returns from direct investments will be sustained. They were nice while they lasted.