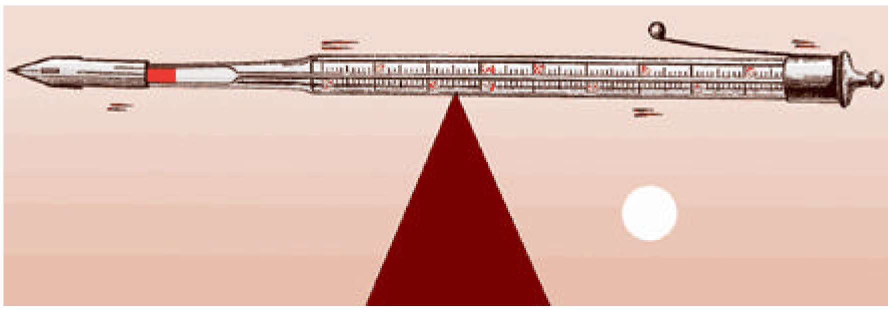
Economist.com LIBRARY SURVEYS

Bond blues

Jan 25th 2001

From The Economist print edition



America's corporate-bond market has reason to be depressed

FOR most of the past two years, America's corporate-bond market has looked positively capricious. Until recently, America's equity markets were soaring, fuelled by an economy that could seemingly do no wrong. By contrast, the corporate-bond market never really recovered from the tumult of autumn 1998, when Russia defaulted and a hedge fund, Long-Term Capital Management, had to be bailed out by its bankers. In recent months, the market has gone through an especially bad patch.

There seemed no rhyme or reason to this. The equity markets, which are supposed to represent a reasonable estimate of the future health of corporate profits and therefore of the economy, appeared to be predicting a cloudless horizon, yet the corporate-bond market seemed to be saying exactly the opposite: the spread of its yields over government bonds suggested a recession, as well as a looming credit crunch in some areas of the market.

Many previously solid credits were treated by investors as little more than pariahs; less secure ones were unceremoniously dumped. The woes of the junk-bond market are relatively easy to explain. The market had grown hugely, mainly because borrowers were able to get startlingly cheap finance from lenders. But that harked back to 1997-98, before the Russian crisis, when investors seemed to have lost sight of the relationship between risk and reward.

Since then the junk-bond market has been in steep decline. By last autumn only about 60 out of a total of 3,000 issuers were prepared to quote prices of a sort for their bonds, reckons Michael Lewitt of Harch Capital Management, a hedge fund. Some dealers took to quoting prices to investors as long as they did not want to deal in them, which did not inspire much confidence in the accuracy of the quotes. Some think that the value of junk portfolios is still overstated by anything up to 20%.

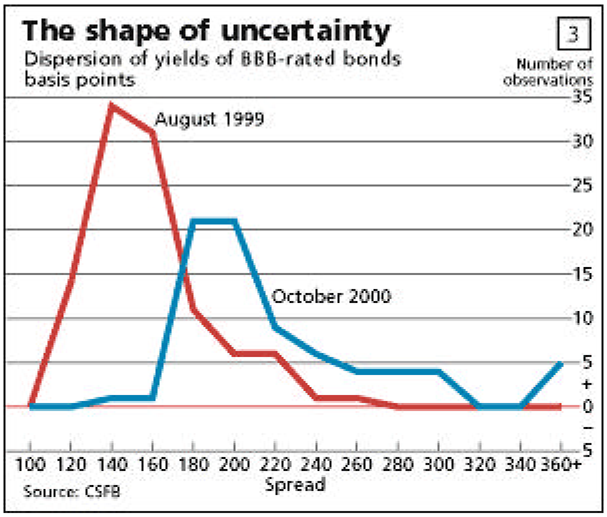
The returns that investors could get from such bonds were measly. In the late 1980s, at the height of the most recent junk-bond boom, investors' rewards for taking risk were high coupons and warrants that allowed them to buy the issuer's equity. In the late 1990s, by contrast, they were given paltry coupons and no equity inducements at all.

Moreover, the quality of those companies that had tapped the market was startlingly poor. The overwhelming majority of the issuers were in cyclical industries or in telecoms; half were rated B or less, Mr Lewitt points out. And some 80% of new issues were private placements for which the investment bankers that brought the deal to the market were not able to do much due diligence.

Of late, credit quality has been getting even worse. John Lonski of Moody's points out that the ratio of upgrades to downgrades is the worst since 1989—ie, just before the last recession. Moody's now expects the default rate to exceed 9% in the next year or so, assuming there is no recession. Investors have woken up to these risks and want to be compensated for them. Yields may have to reach about 20% before investors start to nibble, says Mr Lewitt. Since junk bonds are, to all intents, equity, investors feel they should offer equity-like returns.

No one is safe

The bear market in junk has now spread to some investment-grade credits too. Investors lament that they have had little or no warning from the rating agencies of a series of explosions that have rocked that market. So they are increasingly ignoring the agencies' assessments: the dispersion of yields around individual ratings is wider than ever before (see chart 3).



Xerox, a troubled copier maker, offers a good example of the woes of formerly solid credits. In October, after six profit warnings, its bonds collapsed, but the rating agencies continued to think it worthy of an investment grade. In one day, the spread of its bonds over LIBOR rose from 250 basis points (hundredths of a percentage point) to almost 450 basis points. Only at the beginning of December did Moody's bow to the inevitable and downgrade the firm to junk.

With variations, many other companies have the same story to tell. Retailers (J.C. Penney and Home Depot), funeral parlours, toy makers (Mattel), cinema chains, tyres (Goodyear) and, last but not least, telecoms firms (see article): the list of once-healthy borrowers now shunned by bond investors is lengthening.

Discouraged by poor performance, and encouraged by stellar returns from equity funds, retail investors stampeded out of bond mutual funds. Jim Bianco, who runs an eponymous research firm, estimates that, in the 12 months to November last year, inflows into all mutual funds amounted to about $240 billion. That was roughly the same as in 1993, but with one vital difference: in that year bond funds received roughly half of the money, whereas last year inflows into equity funds amounted to some $340 billion and outflows from bond funds to $100 billion.

The companies wanting to tap the bond market were not generally the same as those driving the equity market. Issuers with an investment grade are almost invariably the stars of yesteryear; it takes years of profits to be awarded such ratings. The companies that had been pushing up the stockmarkets in recent years generally had little debt. But in the quest to make themselves more attractive, those who were shunned resorted to leveraging their balance sheets by buying back their equity.

There are some aspects of corporate finance on which reasonable people can agree, but measurement of a company's leverage—the amount of debt that it has in relation to its equity—does not seem to be one of them. But it is important. Other things being equal, the higher a firm's debt-to-equity ratio, the greater the chances of it defaulting.

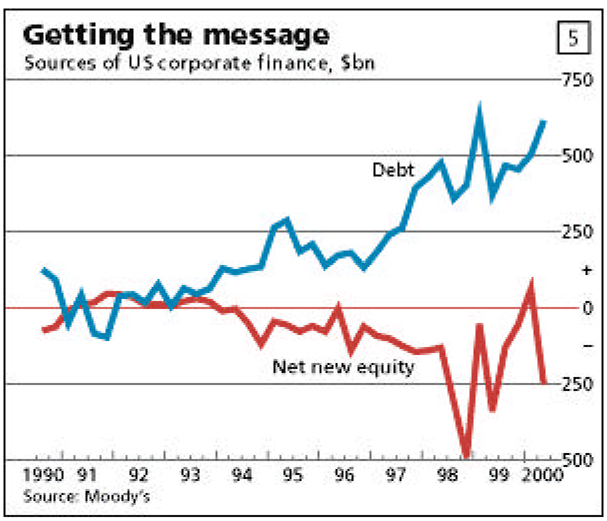
In theory, a glance at a company's accounts should give a fair idea of its equity and debt position. Measuring debt is the easier of the two: firms usually have to pay back money they have borrowed on a set date, so measuring such debt at book value is uncontroversial. Equity is more problematic, because it is not repayable. Sober sorts, such as the rating agencies, look at the book value of that equity and ignore the value that the market attaches to it. As Moody's Mr Lonski explains, to do otherwise would give firms a big incentive to issue debt to buy back their shares.

Furthermore, putting a market value on a company's equity puts leverage ratios at the mercy of the stockmarket. The leverage ratios for junk bonds put out in the 1980s by Drexel Burnham Lambert, an investment bank, used market values, points out Jim Grant, editor of *Grant's Interest Rate Observer*. Perhaps unwisely, Drexel called them Market Adjusted Debt ratios (try the acronym). Certainly the subsequent sharp rise in defaults suggests that this was the wrong measure to use.

And yet, say defenders of using market value, the best guess of the worth of a company's equity is contained in the stockmarket; what it originally cost is irrelevant. Companies can, after all, tap the equity market at roughly the price that the company's shares trade at. And historic-cost or book-value accounting can be used as a cover for all manner of financial shenanigans.

The debate is of more than academic interest. In book terms, corporate leverage for America's non-financial firms rose from 70% in 1997 to 83% in the second quarter of 2000 (and that last figure would have been a lot higher still at an annual rate). For the 50 "admired" companies tracked by Mr Escherich at J.P. Morgan, leverage in book terms climbed, on average, from 19% in 1982 to 28% in 1999; in market terms, it fell from 13% to 5% over the same period. Doubtless, the stockmarket carnage of the past few months has increased that figure. But the point still stands: by market value, leverage seems to have declined, at least for the firms tracked by Mr Escherich.

This seems surprising. In recent years American companies have been the biggest buyers of their own shares. Chart 5 shows how net new equity has declined and debt has risen over the past five years or so.



America's M&A boom has not been paid for entirely with stock: American companies are also raising debt to spend on other companies' shares. Of late, they have been buying companies at the rate of $50 billion a month, compared with about $10 billion a month in the early 1990s, says Steve Zamsky, a strategist at Morgan Stanley Dean Witter.

Perhaps, argues KMV's Mr Kealhofer, the figures produced by Mr Escherich are incomplete. They do not include borrowing that comes from outside the market, such as delaying payment to trade creditors. This has a big effect on the leverage as measured by market value. But higher borrowing is only one reason for bond investors' doubts. They also worry about how well the businesses are doing, and how volatile they are, both of which are reflected in the share price. Although overall stockmarket indices are higher than they were in 1998, the shares of about 70% of quoted companies have dropped, some of them sharply. Firms that saw their shares hammered, apart from Xerox, include Eastman Kodak, Goodyear, Procter & Gamble, and most of the retailing sector, as well as some of the more elderly high-tech firms, such as Dell, Intel, Apple, IBM, and just about the entire telecoms sector.

And worse may be in store, for the volatility of some firms' shares has soared, which implies, in effect, that investors are more worried about their prospects. Again, the overall volatility of the stockmarket does not show up the more extreme examples. The implied volatility (the market's best guess about future volatility) on Xerox climbed from 25% to 70%, and that of Corus, once known as British Steel, doubled, to 60%. Why?

Technological fix

One obvious answer is ever-faster technological change. It may well be that the recent changes in information technology, for example, will ultimately prove less important than the invention of the telephone, the telegraph, trains, cars, or the spinning jenny; but they are undoubtedly happening more quickly. Computers are a lot more powerful than they were, and getting ever more so. The ubiquitous Palm Pilot has more computing power than a desktop computer did ten years ago. Rapid technological change is reflected in the rate of depreciation in America, which has doubled over the past 30 years.

That means companies will have to invest at a higher rate than in the past, says Paul Donovan, an economist at UBS Warburg. If their technologies are new, and untested, most of them are probably unprofitable. They will therefore have to turn to the capital markets and take on debt (remember that most companies dislike issuing equity). "It is safe to assume that in aggregate the new economy will entail a permanently higher rate of borrowing from the corporate-bond market," says Mr Donovan.

But the most important effect of technological change on corporate debt is that rapid creative destruction is, almost by definition, destructive for debt holders. The faster technology changes, the less likely a company is to generate stable cashflows. When Xerox lost its way in the copier market, investors fled. The Internet and e-tailers may have had a nugatory effect on most of the high street, but their effect on profits has been huge at the margin; witness the problems at J.C. Penney and other retailers.

Telecoms provide a splendid example with a subtle twist. First there were fixed-line telecom companies. Then came deregulation and the mobile phone, not to mention other ways of delivering telephone services, such as the Internet. All this has eaten into traditional telecom firms' revenues. In Europe, they decided to bet on the Internet. Hence the huge sums that they have invested in 3G licences, in the knowledge that they will have to spend almost as much again on the infrastructure.

But they probably had little choice. Such was the stockmarket's fascination with the Internet that, had they not invested such large amounts in 3G licences, they would have been punished by a steep drop in their shares. And that, in the conditions prevailing until the middle of last year, would have meant being taken over.

Bond investors, with little upside from the risks taken by companies' management, have taken fright at rapid technological change, increased leverage and the risks posed by a surge in mergers and acquisitions. When all was going swimmingly, shareholders did not care. Now that America's economy and corporate profitability are slowing, they have had second thoughts. Those fears have been compounded by the dawning realisation that many parts of the American stockmarket were absurdly overvalued.