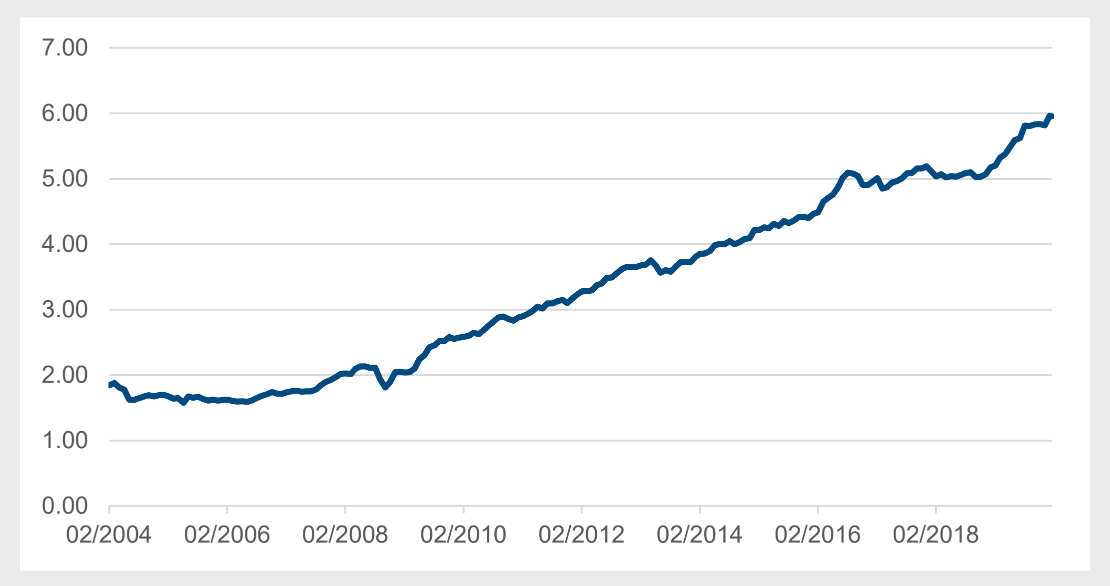
PEAK CREDIT – ARE WE THERE YET?

In recent years, corporate bonds have come to play an increasingly important role in capital markets: a prime example of the disintermediation of the banking system in the post-crisis financial world. Whereas, historically, commercial banks were the first port of call for a company seeking large scale finance, those banks' withdrawal from, or scaling back of, traditional lending activities makes debt issuance the default option for corporate borrowers today.

Happily for those borrowers, thanks to the combined effects of, firstly, the decline of interest rates to historic low levels and, secondly, investors' insatiable demand for income-generating securities, raising capital through the public debt markets has never been cheaper or easier. As a consequence, corporate bond issuance has never been greater.

The graph below charts the growth in the size of the US Investment Grade (IG) corporate bond market since 2004 and also shows the acceleration in that growth that has taken place since the global financial crisis from USD2 trillion in 2008 to USD6 trillion today. Though on a smaller scale, the equivalent charts for the Eurozone and UK look very similar and as a result, the total amount of IG corporate bonds denominated in those three currencies at the end of last year was somewhere in the region of USD10 trillion.

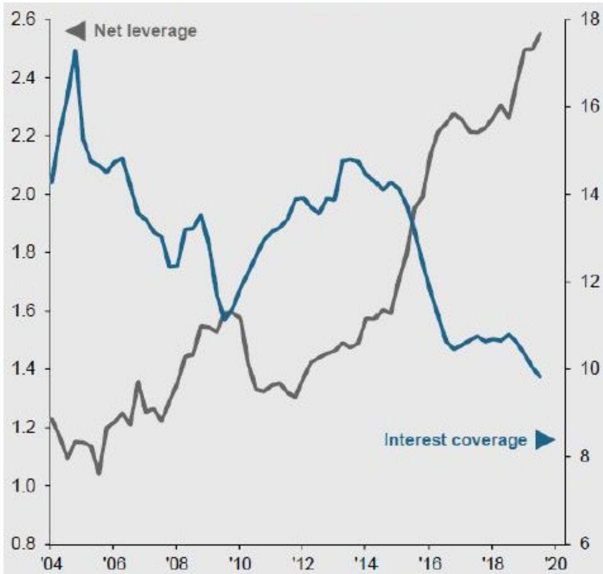
US Investment Grade corporate bond market USD Trillion



Source: Bloomberg

During that same period, the quality of IG bond issues has deteriorated meaningfully. Per our second chart, balance sheet leverage, as measured by net debt to EBITDA, has risen significantly, while the ability of those (US) corporates to service their debt (*i.e.* interest coverage) is much reduced. Another way of measuring this is that the proportion of bonds with the lowest IG rating - BBB - that make up the US IG universe has grown from around 15% of the market to somewhere north of 45%.

US investment-grade leverage measures



Source: JP Morgan

In spite of this, demand for corporate bonds shows no sign of abating, indeed, the price that investors are willing to pay for IG credit, as measured by the average yield spread above US Treasuries, is both close to the highest it has been since 2008 and approaching the pre-crisis peak.

Having established then, that by a number of measures, corporate bonds are pretty much as expensive as they have ever been, is this something to be worried about and/or requiring action within our portfolios? Well, yes in the long term, but not immediately.

Even after noting the inferior fundamentals highlighted above, IG corporates are still comfortably able to service their current debt and we expect this to remain the case as long as interest rates remain low. To that end, with Central Banks back in dovish mode, the timescale for a reversal in the rate cycle appears to have been extended. This, coupled with ongoing strong demand for yielding assets means that, even if we have reached peak credit (and we'll only know that with the benefit of hindsight) the likelihood of a sharp reversal in corporate bond markets is, in our view, remote.

Shaun McDade
Head of International Portfolio Management

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