Market Bulletin

March 26, 2019

Five things to know about the corporate debt market

In brief

- Investors are concerned about the deterioration of corporate debt quality, marked by lower credit ratings and a large share of covenant-lite issuance in the loan market.
- Credit is typically a non-recessionary asset class and should perform well so long as there is no impending recession, which at the moment looks unlikely.
- Corporate bonds still add value in portfolios. But changes to the structure of the corporate bond market mean investors should have an understanding of any new risks.

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Corporate debt as a share of gross domestic product has risen dramatically through the last decade, and with it, leverage has increased and credit quality declined. As a result, many investors are left wondering if credit markets could be the harbinger of the next economic downturn. This paper outlines five key post-crisis changes to the most transparent sector of corporate debt—the public debt market—to address this concern.

1. The corporate bond market is growing fast

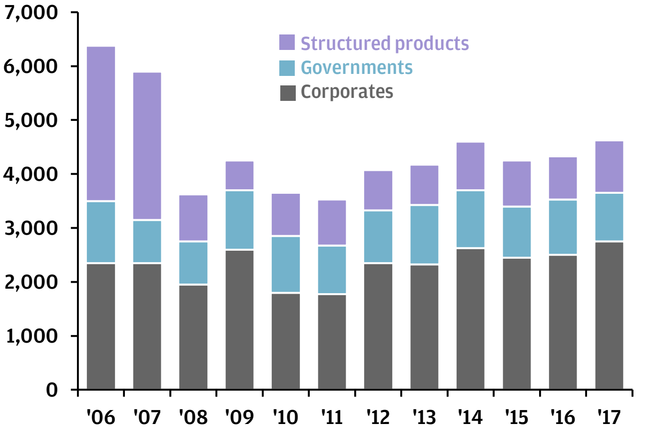
The global debt market has changed dramatically over the last 12 years. In 2006, structured products accounted for 45% of all issued debt. After the global financial crisis (GFC), the fallout from the sub-prime mortgage market, a tighter regulatory framework and an increase in financial institution risk-awareness led to a 50% decline in the issuance of structural products.[1] Corporate bond issuance rose to fill the gap leading to an evolution in the structure of debt markets, and since 2009 corporate bonds have accounted for 57% of all issuance. The combination of extremely low borrowing costs and yield hungry investors (27% of global government debt yields less than 0%) created the perfect environment for both rising demand and supply. A larger market in itself does not pose an immediate threat, so long as company fundamentals are strong enough to maintain coupon payments and avoid defaults.

[1]Structured products are non-traditional financial assets that are typically connected to a basket of market-linked financial instruments. Examples of structured products include mortgage backed securities (MBS) and asset backed securities (ABS).

Post GFC, corporate bond issuance has been a greater proportion of all newly issued debt

EXHIBIT 1: NEW ISSUANCE BY CATEGORY

USD BILLIONS

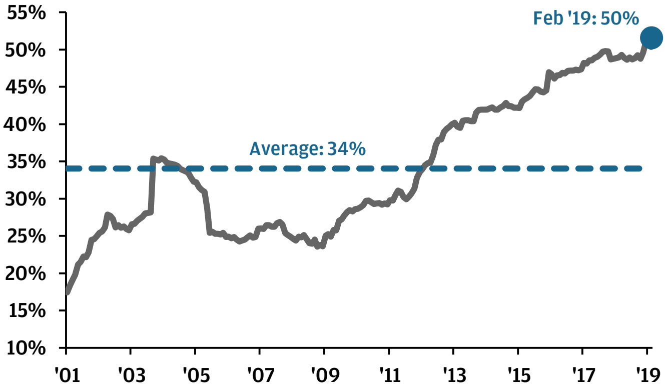


Source: S&P Global, J.P. Morgan Asset Management. Data excludes student loans, private placement, retail notes, commercial paper, agency issues and confidential transactions. Data includes convertibles, preferred equity issuance. EMEA and Asia Pacific data includes home equity loans. Data are as of March 25, 2019.

The quality of the investment grade bond market has deteriorated

EXHIBIT 2: PERCENTAGE OF THE INVESTMENT GRADE BOND UNIVERSE RATED BAA

%



Source: Barclays, Bloomberg, J.P. Morgan Asset Management. Data are as of March 25, 2019.

2. The quality of investment grade debt is in decline

Investment grade corporate bonds are like cuts of beef: at the top-end there is the tender filet mignon (AAA-rated bonds), and at the bottom, the still-delicious but tougher rump steak (BAA-rated bonds). When investors buy investment grade bonds, they may think they are getting the prime cuts but actually end up with the rump without being compensated for it.

With low borrowing costs and investors desperate for yield, companies rationally altered their capital structures or financing methods by issuing debt. However, rising leverage and a potentially-weaker credit position have created an overall decline in the quality of corporate bond indices. Between December 2008 and January 2019, the share of the lowest-ranked bonds in global investment grade corporate bond indices has doubled from 24% to 50%.[2] This change is not unique to the U.S. market and is reflected in the credit markets of most developed countries. In the U.S., this percentage has shifted from 33% to 50% and in Europe, the figures are 18% to 52%. Emerging markets have experienced a similar deterioration in quality but the magnitude is much smaller. In the high-grade market in Asia Pacific, for example, BBB bonds have risen from 6% of the domestic bond universe to just 23%.

The deterioration in index quality is a worrying trend, but there are mitigating factors when assessing the overall level of risk. For example, many companies have used the easy funding environment to refinance existing debt at more favorable rates and extend their debt maturity profile. As a result, if rates start to rise and financial conditions tighten, the pressure on funding costs will only be gradually felt.

Beyond this, credit is often thought of as a non-recessionary asset, in that it offers low levels of return and income so long as the economic outlook is benign. But in the event of an economic slowdown, low quality investment grade debt could be downgraded to junk status. If investors are forced to reposition their portfolios as their bond holdings no longer meet their risk parameters, more severe market dislocations are likely.

The downgrade risk is minimal outside of a recession, and most recently, the reverse has been true. Over the last two years, the amount of U.S. high yield debt becoming investment grade is roughly three times that of bonds moving the other way. Nonetheless, while a near-term recession is not our base case, the end of the credit cycle is inevitable. At that point, an active understanding of portfolio composition can help to avoid the potential impact of downgrades.

[2]BAA bonds in the Bloomberg Barclays Global Corporate Bond Aggregate Index. Comparable bonds in other indices are rated BBB.

3. Lenders have less protection

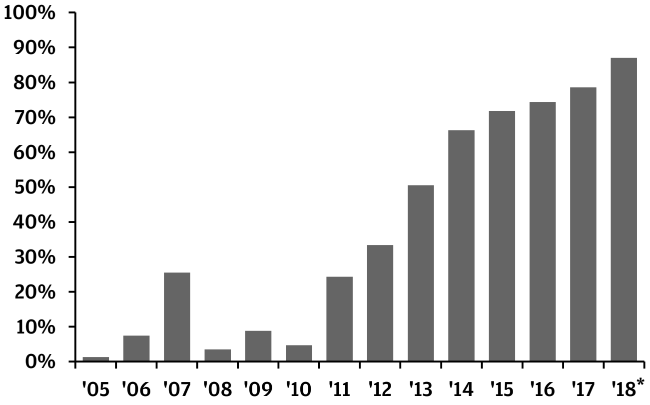
The deterioration in corporate bond market quality is not limited to the top end of the bond market. Other segments of the debt market have been made vulnerable by the dilution and removal of protection for the buyers of bonds.[3]

In 2018, an estimated 87% of leveraged loan issuance was considered to have a lower-than-normal level of protection for bond holders. These types of loans are known as covenant-lite (cov-lite), where investors do not require borrowers to commit to maintain certain financial ratios. Growth in this market has been driven by an increased level of private equity ownership, and their preference to raise capital with more favorable terms for the lender in the leverage loan market.

The sharp rise in 'cov-lite' loans is a worrying trend

EXHIBIT 3: PERCENTAGE OF LEVERAGE LOAN ISSUANCE CONSIDERED TO BE 'COV-LITE'

%



Source: J.P. Morgan Asset Management. *2018 number is an estimate. Data are as of March 25, 2019.

The default rate is running below the long-run average, but an untimely end to the credit cycle or an increase in market stress could drive defaults. Moreover, while the explosive growth in the leveraged loan market and contemporaneous decline in quality shares similarities with the pre-crisis U.S. sub-prime market, the removal of covenants is unlikely to result in severe global contagion: a large proportion of loans are held by institutions rather than banks and retail investors, which reduces the systemic risk.

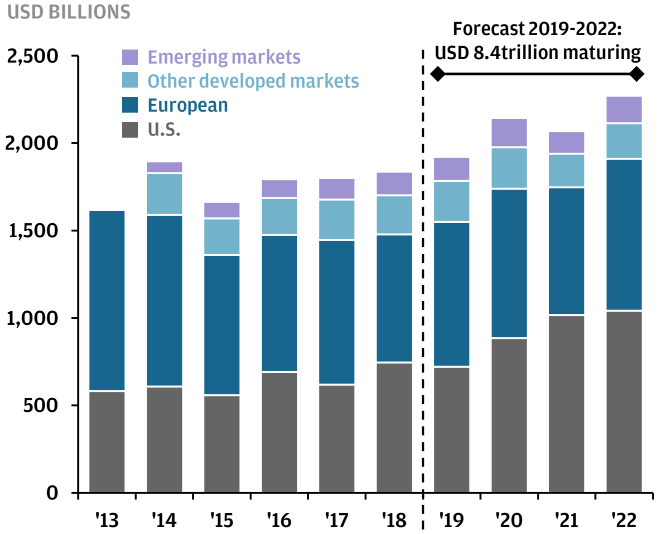
4. A debt wall is approaching

Between 2019 and 2022, USD 8.4trillion of bonds will mature in global corporate debt markets, a record for this economic expansion. This is known as the "maturity wall", and investors are concerned for two reasons: first, large maturity walls are challenging when interest rates are rising as companies are forced to refinance debt at higher rates at the expense of profitability; and second, the interest coverage ratio, or the number of times a company's earnings can cover its interest expenses, has fallen from 8.6x in 2012 to 7.3x in 2018, close to the lowest level since 2009. Taken together, these two factors suggest that spreads could widen if firms face increasing pressure to service their debt.

A looming wall of debt has unsettled bond investors

EXHIBIT 4: MATURITY WALL FOR CORPORATE DEBT

USD BILLIONS



Source: S&P Global, J.P. Morgan Asset Management. Maturity wall is the amount of principal debt maturing for investment and speculative grade debt. Other developed markets and emerging market maturity data is not available for 2013. Data are as of March 25, 2019.

The expansion-long hunt for yield has created natural demand for corporate bonds helping to keep interest rates low. This should help ease the pressures of the approaching maturity wall. Nonetheless, investors should remain cautious given current cycle positioning. As maturing debt is rolled over, the focus should be on quality of issuance and those bonds that offer more protection for bond holders, even if that means sacrificing some additional yield.

[3]These protections are often called covenants, which are legal agreements, or safety nets, placed into bond contracts to force restrictions on bond issuers. For example, common bond covenants typically include a company not violating a certain financial metric threshold, like interest coverage or debt-to-equity. Bond covenants could also cover changes in ownership or potential M&A activity.

5. Much of the debt has not been used for investment

In a perfect world, the money raised from issuing debt would be allocated to inward investment, including research and development and boosting productivity as a means to grow profits. For many investors, the use of corporate debt has been a point of focus. As it turns out, over the course of this cycle, debt not used for refinancing has been put toward mergers and acquisitions (M&A) activity, share buybacks and dividends.

Within the U.S. investment grade market, the data on the use of bond proceeds are minimal, other than to specify whether or not funds are allocated to M&A activity. Since 2015, 29% of non-financial U.S. corporate debt issuance has been for M&A purposes. By contrast, the data for leveraged loans and U.S. high yield bond issuers are more robust. Since 2010, 60% of issuance has been dedicated to refinancing existing loans, with a further 27% being dedicated to M&A activity. Overall, only about 8% of issuance has been focused on “general corporate” activities, which includes business spending and investment.

In general, firms generally have the financial flexibility and a commitment to preserving their investment grade rating. However, the use of the debt is just as important as its quality. A company issuing debt to artificially increase its intrinsic value could be raising leverage without the ability to repay borrowers.

Investment implication

As investors have been starved of income throughout this expansion, the corporate world has responded by issuing an increasing amount of debt of lower quality. Something that many investors have been willing to overlook.

The structural changes to global debt markets may not present an immediate threat to portfolios, especially in an environment where the bias of central banks’ has swung away from tighter policy. However, with renewed fears about the end of the credit cycle, the risks of what this dynamic may mean for markets is becoming increasingly prominent.

Part of having a resilient portfolio is understanding what you own and being aware of where the risks lie. Or at least being adequately compensated for that risk. The falling quality of the corporate debt market means that in the next downturn, corporate debt markets are likely to be more positively correlated with equity market performance, providing very little protection for investors.

Moreover, while pockets of the global debt market may be showing some signs of stress (e.g. BAA rated investment grade bonds), many other parts still offer an attractive source of return or income, such as emerging market debt or high yield. As a result, investors should adopt strategies that allow for some flexibility around bond benchmarks, both geographically and across different segments of the fixed income market.

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