Opinion **Markets Insight**

Coronavirus raises the risk of real trouble in corporate bonds

Even the Fed's rate cut cannot prevent economic 'sudden stops' that will hurt business

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Sudden sell-offs in markets have a nasty way of exposing vulnerabilities that take on a disruptive life of their own, and risk amplifying the initial shock through a self-feeding cycle.

It is important to remember, in this context, the large amount of US investment-grade corporate debt that hangs over the high-yield market like a Damoclean sword. Much of it is now facing a considerably higher risk of downgrade, given the inevitable global economic slowdown caused by coronavirus.

The greater the movement down to junk status, the higher the risk of a waterfall of funding dislocations that makes everything worse, financially and economically.

The spread of the virus has triggered simultaneous shocks to demand, supply and finance. The effects are especially severe for those companies operating in disrupted areas such as Wuhan province in China and Northern Italy, and in disrupted sectors like airlines, hotels, cruises and even energy. The outbreak has destabilised cost-to-income ratios, through both lower revenues and higher spending, and it has complicated decisions over staffing and inventory management.

At the same time, it has undermined the reliability of supply chains and just-in-time inventory management, while depleting cash reserves. And, for those companies with large amounts of debt payments falling due, it limits what has been, until now, very easy access to credit.

The more the virus spreads, the greater the numbers of economic "sudden stops" around the world, and the harder it is for policies to soften the blow. After all, this is not a financial sudden stop, in which central banks can intervene to ease fears over counterparty risk, fix market failures and help the economic recovery. It is an economic sudden stop that requires decisive progress in reducing community transmission rates, and improving immunity and recovery rates. As such, even dramatic policy actions, such as Tuesday's emergency rate cut by the US Federal Reserve, are ineffective in reinvigorating most stalled economic interactions.

The result is deteriorating credit quality, at a time of poor technical conditions for several segments of the US corporate bond market — which, at some $10tn, is five times as large as it was in 2001, according to BlackRock.

Years of extremely lax financial conditions have encouraged and enabled massive issuance of debt at ever-lower interest rates, including tighter spreads over risk-free government securities. The easier it became for companies to issue bonds, the greater the temptation for companies to engage in what is known as financial engineering to alter their capital structures. This trend has been amplified by private-equity transactions that lever up balance sheets as a matter of course, to fund distributions to investors.

The result is that corporate debt has risen significantly faster than earnings growth and cash balances, resulting in a significant downward ratings migration that now has half of the total investment-grade market clinging to that status with a triple B rating, up from less than one-fifth in 2001. Among the companies on that bottom rung, a third are already rated triple B minus, and thus at greater risk of a downgrade to junk.

The likelihood of a growing number of "fallen angels" comes at a time when the longstanding structural deficiency of the $1.2tn high-yield market — that is, a small base of dedicated investors, relative to the amount of outstanding bonds — is more apparent. Liquidity stress could be exacerbated by a lack of funds willing to cross over into junk territory, put off by sudden spikes in credit spreads and less-friendly trading conditions.

This would not be a notable risk to economic wellbeing and financial stability, were it not for several other developments.

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First, according to the Federal Reserve Bank of New York, net leverage — the ratio between a company's net debt and its earnings before interest, tax, depreciation and amortisation — is roughly equal for triple B rated bonds and high-yield debt. Investment-grade bonds, excluding triple A rated debt, have even higher net leverage than high-yield.

Second, the inability to readily trade high-yield bonds at decent bid-offer spreads will damage the primary market for bond issuance, putting pressure on companies looking to refinance maturing debt.

Third, the proliferation of exchange-traded funds has increased ownership by more flighty investors, while fuelling excessive confidence in a readily-available liquidity management tool for investment portfolios.

Fourth, investors unable or unwilling to sell their high-yield holdings will tend to look for other assets to offload, spreading disruptions from one market to another.

Finally, the enormous growth of this debt market has been accompanied by a sharp fall in intermediaries ready to make markets in times of stress.

Now, both companies and investors must navigate the economic and financial effects of the coronavirus that heighten credit risk while sucking liquidity out of the bond markets. The longer it takes to contain these spillovers, the larger the credit downgrades, the higher the threats of default — and the greater the likelihood of financial markets contaminating the economy.

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