Rate hike impact? Credit market cracks widen as distressed debt nears $650 bn

BLOOMBERG
28 December

Multiple stress points are emerging in credit markets after years of excess, from banks stuck with piles of buyout debt, a pension blow-up in the UK and real-estate troubles in China.

With cheap money becoming a thing of the past, those may just be the start. Distressed debt in the US alone jumped more than 300 per cent in 12 months, high-yield issuance is much more challenging in Europe and leverage ratios have reached a record by some measures.

The strains are linked to aggressive rate increases by the Federal Reserve and central banks around the world, which have dramatically changed the landscape for lending, upended credit markets and pushed economies toward recessions, a scenario that markets have yet to price in.

Globally, almost $650 billion of bonds and loans are in distressed territory, according *Bloomberg*.

It's all adding up to the biggest test of the robustness of corporate credit since the financial crisis and may be the spark for a wave of defaults.

Banks say their wider credit models are proving robust so far, but they've begun setting aside more money for missed payments, data compiled by *Bloomberg* show.

Loan-loss provisions at systematically important banks surged 75 per cent in the third quarter compared with a year earlier, a clear indication that they are bracing for payment issues and defaults.

Most economists forecast a moderate slump over the next year. A deep recession, however, could cause significant credit issues because the global financial system is "vastly over-leveraged," according to Paul Singer's Elliott Management Corp.

Right now, the outlook for economic growth is a concern. Rolling recessions are likely across the globe next year, with the US likely to slip into one in the middle of next year, Citigroup economists wrote in a note. The first half of 2023 will be "bumpy" and "characterised by higher for longer volatility" Sue Trinh, co-head of global macro strategy at Manulife Investment, said on *Bloomberg*.

That market has ballooned in recent years. There was $834 million of leveraged loan issuance in the US last year, more than double the rate in 2007 before the financial crisis hit.

As demand grew, so did the risk. In new US loan deals this year, total leverage levels are at a record versus earnings, data compiled by Pitchbook LCD show. There's also a looming earnings recession there, Morgan Stanley strategist Michael Wilson has warned. Leveraged loans have seen the "greatest buildup of excesses or lower-quality credit," according to UBS strategist Matt Mish, Default rates could rise to 9 per cent next year if the Fed stays on its aggressive monetary-policy path, he said. It hasn't been that high since the financial crisis.

ILLUSTRATION: BINAY SINHA

Restrictive rates

Many investors may have been caught out by the Fed this year. They've consistently bet that the threat of recession would force the central bank to ease off, only to have been repeatedly burned by tough talk, and tough action. While the pace of hikes has slowed, Chair Jerome Powell has also been clear that rates still have to go higher, and will stay elevated for some time. The Secured Overnight Financing Rate, a dollar benchmark for pricing, is about 430 basis points, an 8,500 per cent increase since the start of the year.

In this new world of higher interest rates and a greater risk aversion, there's already a squeeze on global banks, which have been left saddled with about $40 billion of buyout debt ranging from Twitter to auto-parts maker Tenneco Lenders had expected to quickly offload bonds and loans linked to the acquisitions but were unable to do so when the appetite for risky assets plunged as borrowing costs rose.

There's another reason for concern. The search for yield during quantitative easing was so desperate that borrowers were able to soften investor protections, known as covenants, meaning investors are far more exposed to the risks.

For example, more than 90 per cent of the leveraged loans issued in 2020 and early 2021 have limited restrictions on what borrowers can do with the money, according to Armen Panossian and Danielle Poli at Oaktree Capital Management LP.

With markets awash with cash, more firms opted for cheap loans that had few covenants, something that's altered balance sheets.

Historically, corporates typically used a combination of senior loans, bonds that ranked lower in the payment scale and equities to fund themselves. Over the last decade, however, demand has allowed firms to cut out the subordinated debt, meaning investors are likely to get less money back if borrowers default.

Almost 75 per cent of issuers in the US have only loans in their debt capital structure, according to JPMorgan Chase & Co, compared with 50 per cent in 2013.