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Business Trend: Debt Markets - The Canary in the Coal Mine

Doylestown, PA | Pittsburgh, PA | Buffalo, NY

Debt Markets: The Canary in the Coal Mine

- Many Investors and Economists look to the debt markets for early indications of economic trouble.
- On the surface the waters look calm, but below the surface, risks are building.
- The interest spread between Corporate debt and U.S. Treasury debt is small indicating investors are taking higher risk without commensurate payment. This happened before in the late 1990s and 2007.
- Covenants in the leveraged loan markets have loosened. Another sign of high risk-taking.
- 40% ($3 Trillion) of US corporate bonds are currently rated BBB– a stone's throw from junk bond status. This is the highest percentage (and amount) of on-the-cusp bonds ever recorded.
- Increasingly creditors are restricting credit availability in riskiest of sectors (the 2008 crisis started in the subprime sector but the contagion quickly spread to virtually all sectors)
- Interest rates are rising which will: make all floating debt more expensive to service, prevent some companies from refinancing and tip marginal companies into junk status.
- Over the past few months the issuance of investment grade debt has dropped by 35% and Investors have been aggressively selling their debt instruments.

Debt Markets: Risks, Concerns & Potential Outcomes

Risk	Concern	Potential Outcomes
The overall level of risk taking in the debt markets is very high.	High levels of risk create instability and volatility particularly when investors begin to shun high-risk debt sectors. Frequently the contraction contagion spreads into all sectors.	The worst case is that a series of defaults could trigger a domino default scenario similar to 2007. A lesser outcome could be the exacerbation of contractions of debt availability.
40% of all Corporate Bonds are rated BBB.	Too Many companies are too close to the junk line and if a recession hits many will be plunged into junk status and their debt cost couuld increase by 50% or 250 BP or more causing bankruptcies .	In a good economy 10% of BBB- bonds annually slip into junk status, if the economy falters its not hard to imagine 25% of these companies or $0.75 Trillion of debt could be downgraded. With downgrades come increased borrowing costs and the inability to roll over debt a frquesnt precurser to bankruptcy.
Contractions of Debt Availability are occuring in some risky sectors like leveraged lending.	Debt availability contractions ususally begin at the riskiest corners of the market, but the contagion then impacts the entire market.	The lack of liquidty (banks unwilling to lend/ investors unwilling to underwrite bonds)is what bankrupts companies and throws economies into recessions .
Interest Rates are Increasing	The Fed has agressively raised interst rates as of late and has strongly hinted that they will continue to increase short term rates. The higher rates negatively impact all of these risks and increases the probability that all of these risks occur.	If the Fed tightens rates beyond what is required to keep inflation in check it will likely trigger a recession, the severity of the recession will be contingent upon how the other listed risks react.

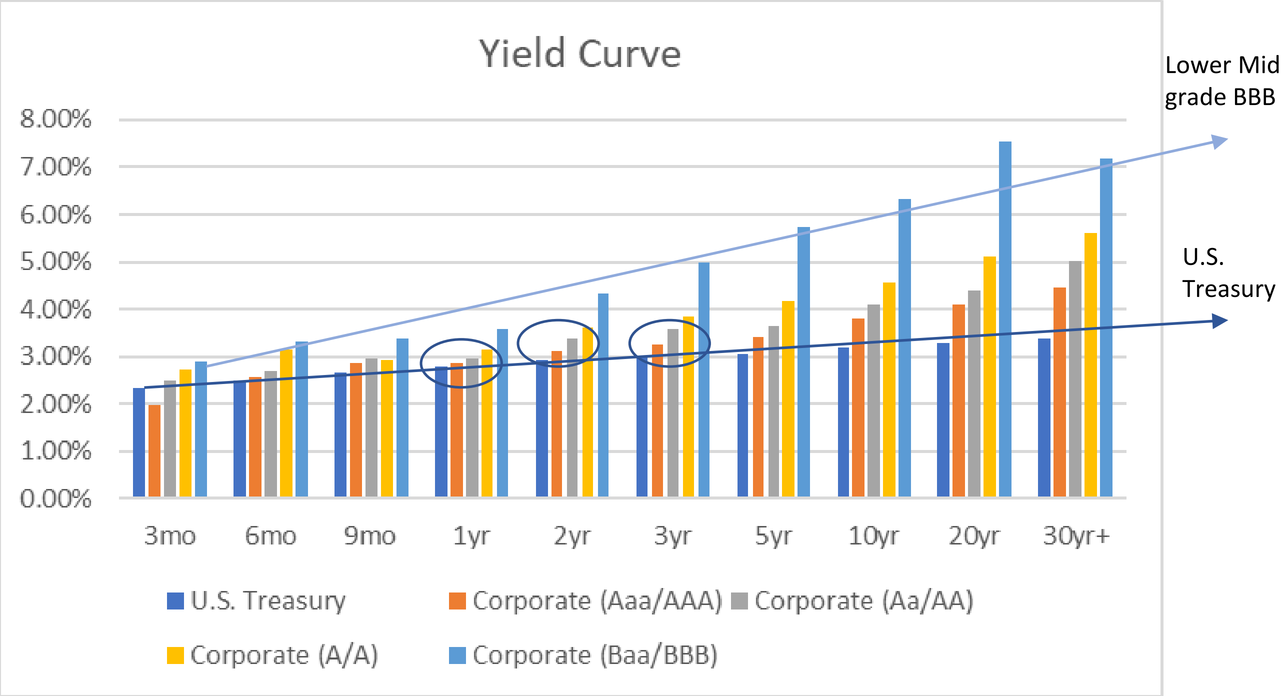
Feedback Loop: One risk impacts all others

Debt Markets: Interest Rates are Rising and are Expected to Continue to Rise

The benchmark 10-Year Treasury Rate began to increase in late 2017 and has continued to increase.

Fed Watchers expect one more 0.25% hike before year end and approximately three more times in 2019 in 0.25% increments.

Debt Markets: Interest Rates are Rising and are Expected to Continue to Rise



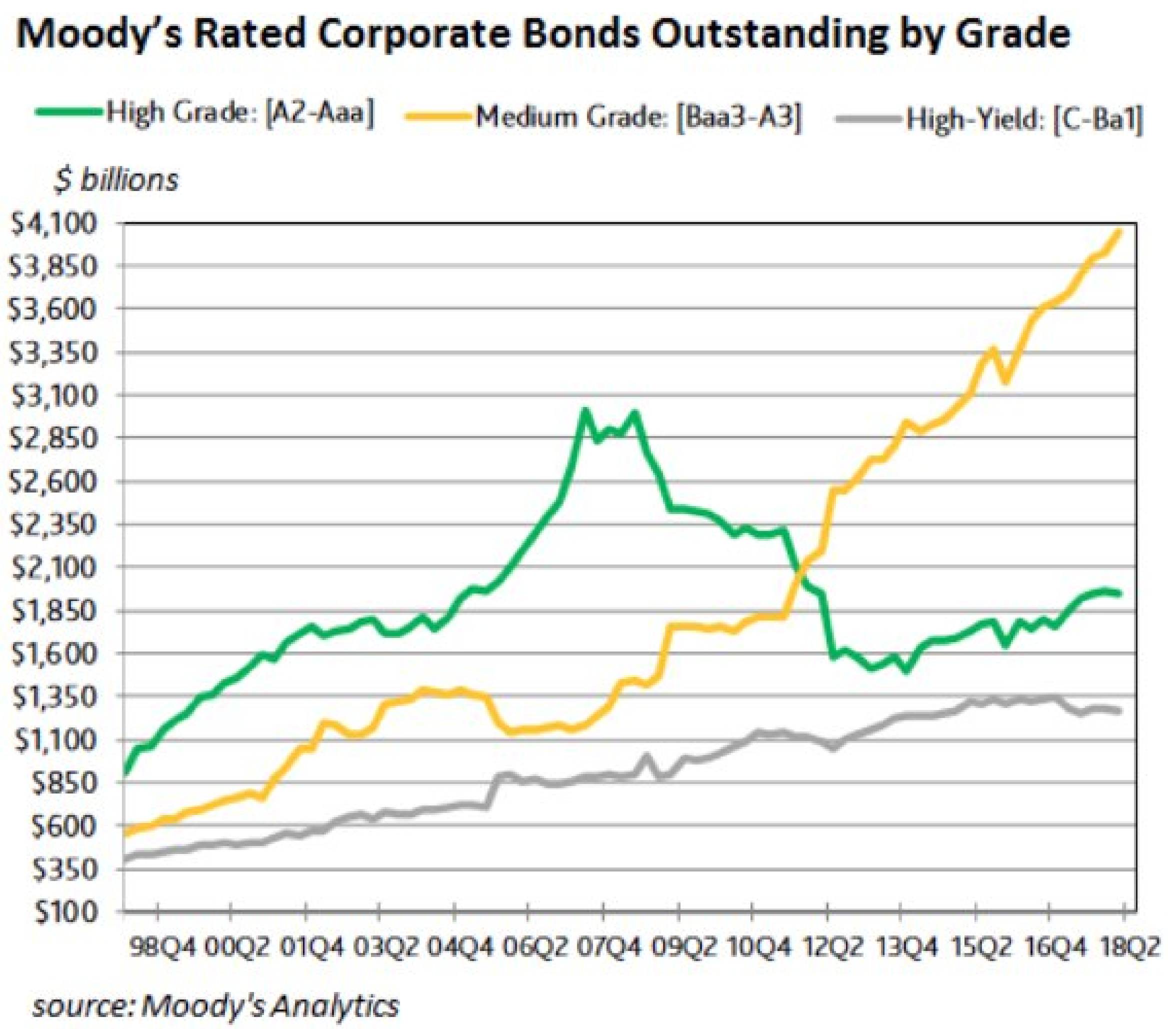
Although the yield curve is positive for Treasuries and all four grades of corporate bonds, the curve is most pronounced in the BBB sector where investors are demanding more compensation for taking long term risks.

The market isn't demanding much of a risk premium between Treasuries and AAA, AA and A corporate bonds (see 1, 3 and 5 years)

YIELD CURVE	3mo	6mo	9mo	1yr	2yr	3yr	5yr	10yr	20yr	30yr+
U.S. Treasury	2.34%	2.51%	2.67%	2.78%	2.93%	2.98%	3.04%	3.18%	3.28%	3.38%
Corporate (Aaa/AAA)	1.98%	2.58%	2.85%	2.85%	3.13%	3.26%	3.42%	3.82%	4.09%	4.46%
Corporate (Aa/AA)	2.51%	2.69%	2.96%	2.96%	3.39%	3.58%	3.64%	4.10%	4.39%	5.01%
Corporate (A/A)	2.73%	3.14%	2.93%	3.14%	3.61%	3.85%	4.17%	4.55%	5.11%	5.62%
Corporate (Baa/BBB)	2.89%	3.31%	3.38%	3.59%	4.33%	5.00%	5.75%	6.34%	7.54%	7.17%

The outlier in the investment grade bond market are the BBB issues. Longer term BBBs are yielding between 1.5% and 2.5% higher as investors are worried about the prospects of BBBs

Debt Markets: "Medium Grade" Issuances -Just Above Junk- Dominates Bond Outstandings



With the absolute cost of debt so low, Corporate Chief Financial Officers ("CFOs") are using bonds and leveraged loans as the capital funding source of choice. In addition to using debt for traditional purchases like asset acquisitions, CFOs have increasingly used debt to fund equity buy- backs to support stock prices.

Going forward the combination of rising interest rates and increased leverage ratios will put pressure on some companies to limit buy back programs and for others it may push the credit ratings into junk territory. In both instances stock prices are likely to decline.

Debt Markets: As the BBBs Go, So Do We

Broad Categories	Long Term Ratings Agency Scale			Refined Categories	Bonds In Categories
	Moody's	S&P	Fitch		
Investment Grade Debt	Aaa	AAA	AAA	Prime	$2.00 Trillion Billion High Grade A2-Aaa / A-AAA
	Aa1	AA+	AA+	High grade	
	Aa2	AA	AA		
	Aa3	AA-	AA-		
	A1	A+	A+	Upper medium grade	
	A2	A	A		
	A3	A-	A-		$4.0 Trillion Medium Grade Baa3-A3 / BBB-A-
	Baa1	BBB+	BBB+	Lower medium grade	
	Baa2	BBB	BBB		
	Baa3	BBB-	BBB-		
Below Investment Grade Debt AKA "Junk" or "High Yeild"	Ba1	BB+	BB+	Non-investment grade speculative	$1.34 Trillion Non Investment Grade C-BA1/BB+-D
	Ba2	BB	BB		
	Ba3	BB-	BB-		
	B1	B+	B+	Highly speculative	
	B2	B	B		
	B3	B-	B-		
	Caa1	CCC+	CCC	Substantial risk	
	Caa2	CCC		Extremely speculative	
About to Default or In Default	Caa3	CCC-		Default imminent with little prospect for recovery	
	Ca	CC			
		C			
	C	D	DDD	In default	
	/		DD		
	/		D		

40% of the Debt Market carries a BBB rating and much of it at the lower end of the scale.

How the issuers of these securities perform over the coming months and years may determine if the economy continues to chug along or derails into a recession

Debt Markets: So, Which Canaries to Watch?

If the debt markets are truly the canaries in the coalmine and their risks are the harbingers of recession, which canaries should we watch?

#1 Fallen Angels, those whose debt was previously rated investment grade, but who were subsequently downgraded to junk status. With 40% of the Corporate debt market on the BBB/BB cusp any major uptick in downgrades and/or defaults has the ability to act as a contagion in the broader debt markets.

#2 The Fed Funds Rate (the rate the Fed changes in an effort to influence all other rates). Traditionally the Fed begins to raise this a little to late in the game, when markets are already overheated and inflation has started to climb and unfortunately they tend to keep raising rates while they wait for the threat of inflation to pass and inadvertently plunge the economy into recession.

#3 Watch how debt investors act in the high risk corners of the market like junk bonds, leveraged loans, subprime loans and CDOs (yes they are back). Do they continue to invest, curtail their new investments, or do they withdraw their funds.

The debt markets continue to look placid at least on the surface, but the level of risk is certainly rising.