The Big, Dangerous Bubble in Corporate Debt

By William D. Cohan
Mr. Cohan is a former investment banker and the author of four books about Wall Street.

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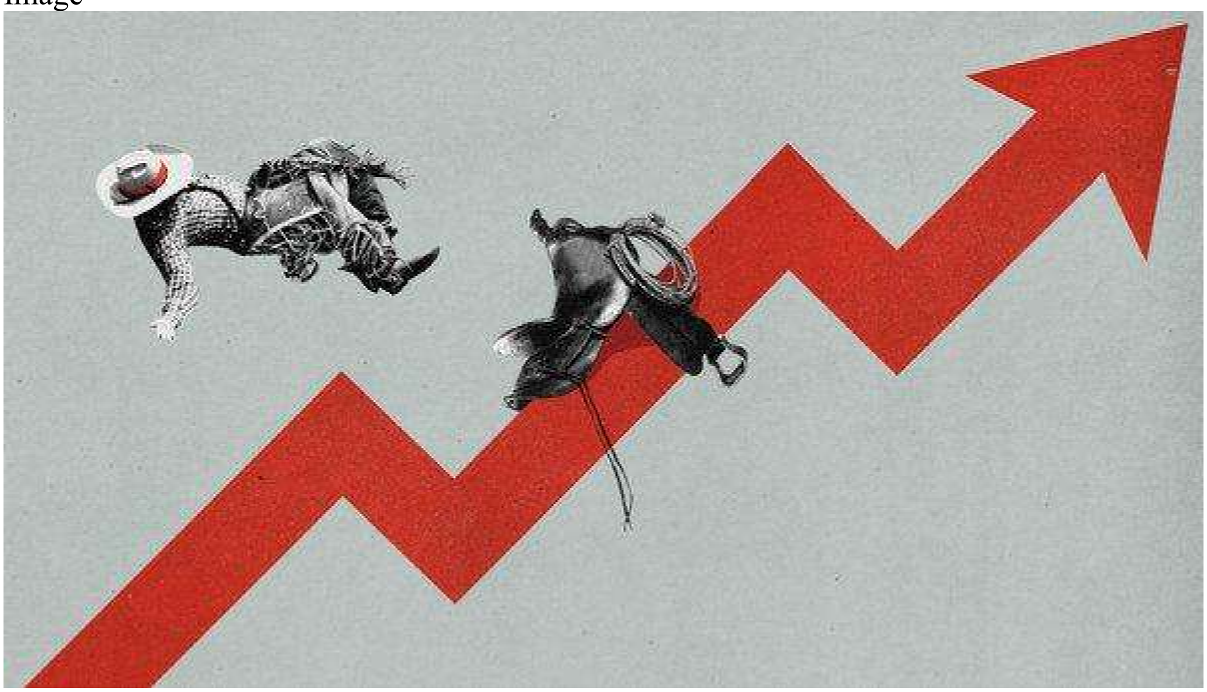

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The $30 trillion domestic stock market seems to get all the attention. When the stock market sets new highs, we instinctively feel things are good and getting better. When it tanks, as happened in the initial months of the 2008 financial crisis, we think things are going to hell.

But the larger domestic debt market — at around $41 trillion for the bond market alone — reveals more about our nation's financial health. And right now, the debt market is broadcasting a dangerous message: Investors, desperate for debt instruments that pay high interest, have been overpaying for riskier and riskier obligations. University endowments, pension funds, mutual funds and hedge funds have been pouring money into the bond market with little concern that bonds can be every bit as dangerous to own as stocks.

Unlike buying a stock, which is a calculated gamble, buying a bond or a loan is a contractual obligation: A borrower must repay a lender the borrowed amount, plus interest as compensation. The upside in a bond is limited to the contractual interest payments, but the downside is theoretically protected. Bondholders expect to get their money back, as long as the borrower doesn't default or go bankrupt.

But for much of the last decade, risk has been mispriced to a staggering degree. In other words, the prices of bonds (and corporate loans) have not accurately reflected the riskiness of the underlying borrower's credit. A company that is a poor credit risk, because it has too much debt or is struggling, should have to pay higher rates of interest. And investors would expect a higher yield — roughly the interest rate divided by the price paid for the bond or loan — for taking on that risk. Since the financial crisis, that simple calculus has been upended. Until recently, investors have been paying higher prices for the debt of riskier companies and not getting properly compensated for that risk.

The International Monetary Fund has noticed. In a recent blog post, an I.M.F. economist wrote that the current debt craze was "fueled by excessive optimism among investors," and he added: "When the economy is doing well and everybody seems to be making money, some investors assume that the good times will never end. They take on more risk than they can reasonably expect to handle."

For now, the bond market, like the stock market, looks robust. It has been a long bull run for both stocks and bonds, and borrower defaults have been at historically low levels for years. As has the "spread"— the difference between the yields — of Treasury-backed securities and riskier bonds. But as interest rates continue to rise, and some companies and other borrowers fail to meet their debt obligations, defaults will inevitably increase along with the spreads.

When they do, trillions of dollars in invested capital could be lost. If that happens, as it did after September 2008, access to credit for most borrowers could dry up, setting off yet another potentially devastating economic crisis.
To be sure, the growing concern about the mispricing of risk doesn't mean we're on the verge of a recession. But the corporate debt bubble inevitably will play a role in causing it.

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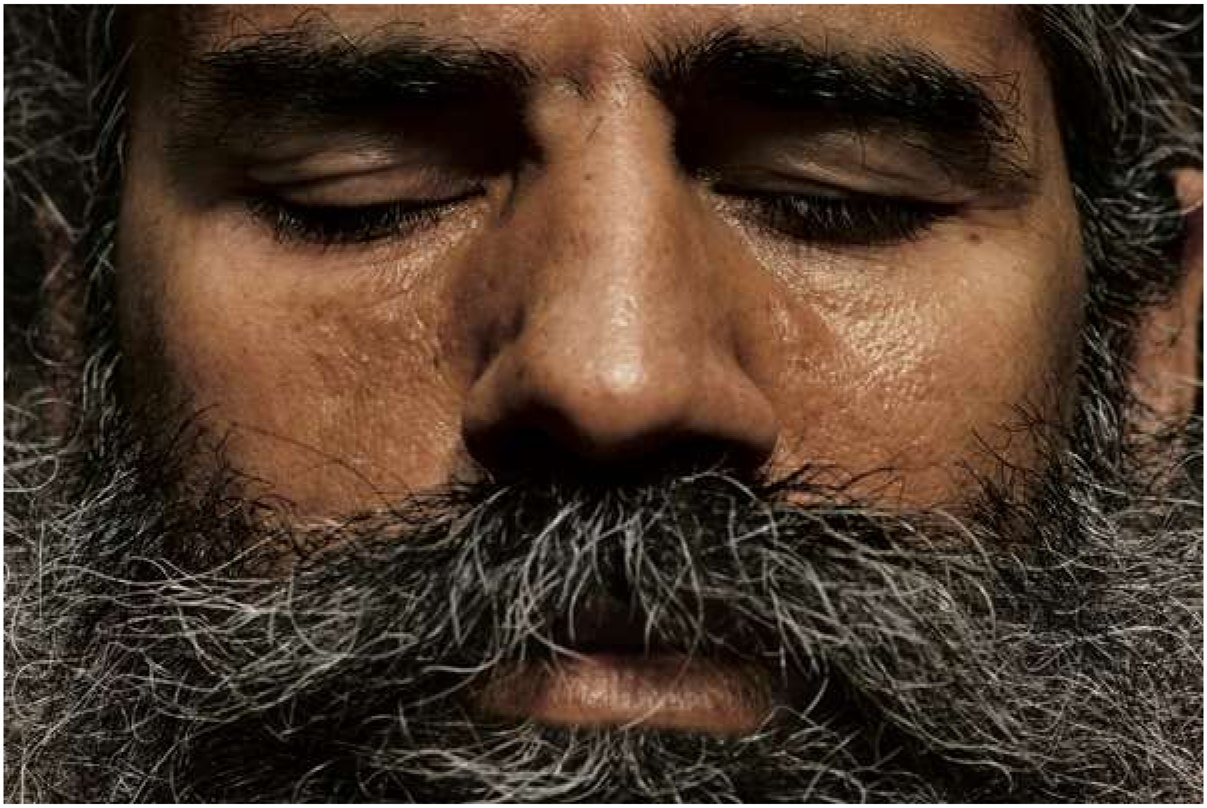

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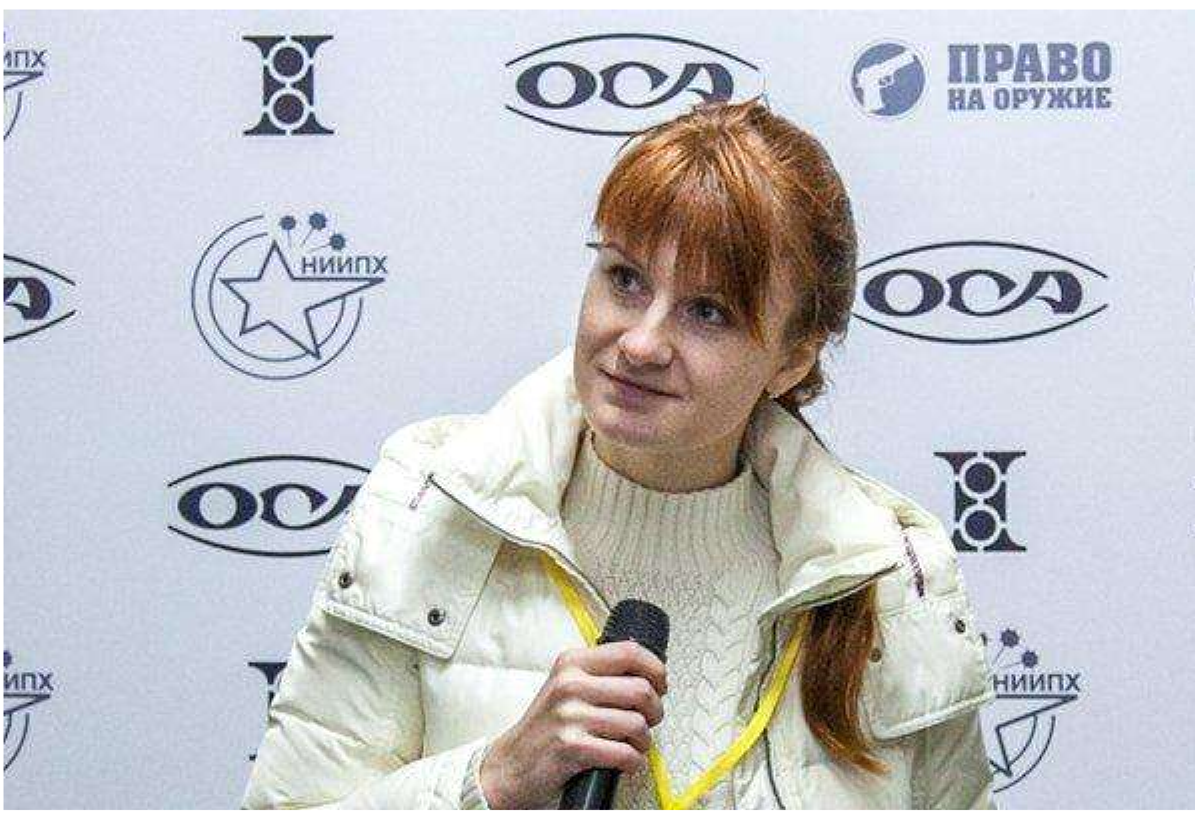

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Here's the crux of the problem: After the financial crisis, the Federal Reserve Board under Ben Bernanke decided to lower short-term and long-term interest rates. Fed officials hoped that by flooding the zone with inexpensive credit, borrowers would have access to money to build new factories, buy new equipment, hire more employees and pay them higher wages. Mr. Bernanke's idea was that the Fed could engineer an economic recovery by making sure that most businesses that wanted capital could get it at an attractive price. It largely worked. His strategy was so successful that it was envied and then copied by central banks around the world.

To lower interest rates, the Fed employed two tactics. One was to cut the so-called Fed Funds rate — what the Fed charges the nation's biggest banks to borrow money on a short-term basis — to nearly zero, and keep it there for seven years. Lowering long-term rates required more creativity. Mr. Bernanke had a clever plan, what he called "quantitative easing": The Fed would buy trillions of dollars of toxic securities that had marred the balance sheets of the Wall Street banks.

By creating artificial demand for these securities, where there had been virtually none, the Fed helped big banks cleanse their balance sheets, reassuring investors and creditors. But like anything else, bond prices are subject to the vagaries of supply and demand; the Fed's gorging drove up not only the price of these particular bonds but also bond prices generally, lowering their yields. (When bond prices increase, yields decrease.)

The plan worked, perhaps too well. Both short- and long-term interest rates were reduced to levels rarely seen in our lifetimes. The Fed's balance sheet expanded to about $4.5 trillion, from less than $900 billion before the crisis, thanks to the purchase of squirrelly assets from Wall Street. The world was awash with cheap capital. (Of course, that didn't mean it was any easier for home buyers to get a mortgage or for small businesses to get loans.)

In the years leading up to the 2008 financial crisis, a sustained period of low interest rates led to a widespread deterioration of credit standards for mortgages, among other securities. The same thing is happening now for other kinds of loans and debt instruments. Only this time, the Fed has kept interest rates lower for longer.

An unintended consequence of keeping interest rates artificially low for so long is the mispricing of risk. The Fed's artificial demand has kept bond prices higher than they otherwise would have been, and their yields lower. But investors have an insatiable demand for higher yields, a collective hunger that Wall Street has been only too happy to feed.

Examples of mispriced risk are strewn across the financial landscape. In June, Asurion, an insurer of cellphones, closed on a $3.75 billion loan package from Wall Street's biggest banks, with minimal covenants — agreements to protect creditors by notifying them when certain red flags, like a higher than agreed-upon debt-to-cash flow ratio, are waving.

The proceeds of Asurion's "covenant-lite" or "cov-lite" loan were used to pay dividends to the three private-equity firms that own the company. Its debt load has increased to $11.3 billion, seven times its cash flow. For additional irresistible fees, Wall Street then repackaged the Asurion loans into securities and sold them to investors, who now own the debt of a highly leveraged company with far fewer protections.

According to LeveragedLoan.com, which monitors the corporate loan market, the issuance of cov-lite corporate loans has exploded in the past few years and reached a record in May. Cov-lite loans now account for nearly 77 percent of the estimated $1 trillion corporate loan market. And some of these loans are packaged and resold as bonds or as other complicated investments.

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To help pay for its recently completed [$8 billion buyout of the margarine and spreads business of Unilever] — since renamed Flora Food Group — KKR, the private equity firm, offered investors 1.1 billion euros (about $1.3 billion) of senior notes with a minimal covenant package. [Moody's rated it 4.99] on a scale of 1 to 5, with 5 being the weakest. Nevertheless, investors gobbled them up.

Or consider the mighty AT&T — now stuffed to the gills with an estimated $180 billion in debt following its $85 billion acquisition of TimeWarner. It is, [according to Moody's], the "most indebted, nongovernment controlled, nonfinancial rated corporate issuer" and one now "beholden to the health of the capital markets." In other words, the company is so indebted that chances are high it will need continuing access to the credit markets to refinance and pay back its mountain of debt as it becomes due.

So-called junk bonds — issued by companies with poor credit ratings — historically have yielded around 10 percent or more, to compensate investors for taking the risk of buying the debt of such companies. These days, junk bonds yield around 6.25 percent, meaning that investors — still desperate for yield — have overpaid for these bonds sufficiently to drive down their effective yields to levels that fail to compensate them for the risks they are taking.

When junk bond yields return to more normal levels, as interest rates rise and investors' yield-fever breaks, the price of the bonds bought during the feeding frenzy will fall and billions of dollars stand to be lost — by endowments, pension funds and high-yield funds, among others — as bonds across the board are repriced by the market.

When that happens, the entire credit market could start to contract, as it did after the 2008 crisis. When the pendulum swings away from fast-and-loose credit standards for corporations, lenders become more cautious. That means ordinary people will pay much higher rates for mortgages, car loans and small-business loans — if they can get them at all.

This is not a minor concern. In a July 30 interview on CNBC, Jamie Dimon, the chairman and chief executive of JPMorgan Chase, America's largest bank, said the biggest risks to the economy were the consequences of tariffs on China and the unwinding of the Fed's quantitative easing policiesand its implications for bond prices and credit markets generally. "I don't want to scare the public," he said, "but we've never had QE [before]. We've never had the reversal."

It may not be too late for a course correction. Banks could tighten their underwriting standards — ratchet down the leverage, demand more covenants, nix loans that are used to pay big dividends — and investors could be more discerning about the prices they are willing to pay for high-yielding bonds. Regulators could be more vigilant about allowing such loans and bonds to be issued in the first place. Wall Street could also redesign its compensation system to reward bankers to be more cautious with their underwriting and to take fewer risks with other people's money.

In the meantime, we must inure ourselves to the inevitable. It may take yet another major financial crisis for things to change, or maybe things will never change. Either way, it’s a lesson we never seem to learn until it’s too late.

William D. Cohan is a special correspondent for Vanity Fair and the author of, most recently, “Why Wall Street Matters.”

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