Fed's $5.7 Trillion Gift Imperiled on Yield Rise: Credit Markets
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By Sarika Gangar, Mary Childs and Charles Mead

June 7 (Bloomberg) -- The most relentless surge in borrowing costs for U.S. corporate debt in four years is threatening to derail this year's record pace of sales as concern deepens the Federal Reserve will curtail unprecedented stimulus.

Yields are climbing for a sixth week from last month's record lows and yesterday touched 3.78 percent, the highest level since September, according to the Bank of America Merrill Lynch U.S. Corporate & High Yield index. U.K. oil-and-gas services provider Petrofac Ltd. cited market conditions for canceling its issue of investment-grade dollar-denominated notes as sales fell below the 2013 average for a second week.

While the Fed has enabled companies to borrow $5.74 trillion in the bond market since the end of 2008 by suppressing benchmark interest rates at close to zero percent, debt investors are becoming more discriminating as policy makers consider tapering their monthly bond purchases. That may blunt the record pace of sales, which reached $757.3 billion this year, after an unprecedented $1.48 trillion of issuance in 2012, according to data compiled by Bloomberg.

Paring Inventories

"Last year we said over and over again that it's an issuer's market and the tables, at least recently, have turned," Jody Lurie, a corporate credit analyst at Janney Montgomery Scott LLC in Philadelphia, said in a telephone interview. "Borrowers are listening to the demand of the investor."

Concern that interest rates will rise further has sparked a sell-off in longer-dated corporate debt, leaving $146 billion of investment-grade bonds in the U.S. with maturities greater than 10 years trading below par, Bloomberg bond index data show. The discount notes have swelled from less than $30 billion at the beginning of May.

Dealers sold a net $3.1 billion of investment-grade notes in the past week, JPMorgan Chase & Co. credit strategists wrote in a note yesterday. The biggest banks are paring inventories even as investors absorb $16 billion of new debt issuance in a weakening market, which is unusual, said the strategists led by Eric Beinstein in New York.

"It may reflect dealers coming into this selloff period longer than they wished," the JPMorgan strategists wrote.
"Presumably they are less long now."

Default Swaps

Elsewhere in credit markets, the cost of protecting corporate bonds from default in the U.S. fell. The Markit CDX North American Investment Grade Index, which investors use to hedge against losses or to speculate on creditworthiness, decreased 2.2 basis point to a mid-price of 81.6 basis points as of 9:43 a.m. in New York, according to prices compiled by Bloomberg.

The index typically falls as investor confidence improves and rises as it deteriorates. Credit-default swaps pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt.

The U.S. two-year interest-rate swap spread, a measure of debt market stress, decreased 0.2 basis point to 16.95 basis points as of 9:44 a.m. in New York. The gauge narrows when investors favor assets such as company debentures and widens when they seek the perceived safety of government securities.

Goldman Sachs

Bonds of Goldman Sachs Group Inc. are the most actively traded dollar-denominated corporate securities by dealers today, accounting for 6 percent of the volume of dealer trades of $1 million or more as of 9:45 a.m. in New York, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority.

Borrowing costs for the riskiest to the most creditworthy issuers in the U.S. have climbed from 3.705 percent at the end of last week after touching a record low 3.35 percent on May 2, Bank of America Merrill Lynch index data show.

The jump in yields, which averaged 4.07 percent in 2012, marks the longest streak of increases since the eight weeks ended Oct. 31, 2008, at the height of the worst financial crisis since the Great Depression.

The extra yield investors demand to hold company bonds rather than government debt increased to 228 basis points as of yesterday from 212 on May 31 after reaching 201 on May 22, the least since Oct. 16, 2007, Bank of America Merrill Lynch index data show.

'Overheated' Market

Sales in 2013 have climbed 17.5 percent from the corresponding period last year, Bloomberg data show. Offerings this week of $15.7 billion followed $14.4 billion in the period ended May 31, a week shortened by the Memorial Day public holiday in the U.S. Weekly sales have averaged $33.7 billion this year.

Offerings of junk-rated notes, graded below Baa3 by Moody's Investors Service and lower than BBB- at Standard & Poor's, accounted for $2.3 billion of the total, the second-slowest week this year, from $2.6 billion in the prior period, Bloomberg data show.

"The new issue market is still very healthy, but it got overheated," said Josh Witz, co-head of U.S. debt capital markets at Societe Generale SA in New York.

Petrofac canceled its offering of five- and 10-year bonds on June 3, according to a person with knowledge of the transaction, who asked not to be identified without authorization to speak publicly.

Sustained Improvement

The bonds had been provisionally rated Baa1, the third- lowest level of investment grade, by Moody's, which cited the London-based company's presence in "fairly resilient markets" and its "conservative financial policies" in a report dated that day.

The five-year notes were marketed at 170 basis points, after initial price guidance of about 150, while the spread on the 10-year securities expanded to 200 from about 187.5 basis points, the person said.

"Despite a reasonable start to the bond launch, during the course of the trading day, the U.S. credit markets weakened in light of broader economic concerns so severely that the process was stopped," Stephen Malthouse, an outside spokesman for Petrofac at Tulchan Communications Group, wrote in an e-mail.

Fed Chairman Ben S. Bernanke told Congress on May 22 that the central bank's policy-setting board could start scaling back purchases in its "next few meetings" if the U.S. employment outlook shows sustained improvement.

'Greater Cost'

Dallas Fed President Richard Fisher said June 4 it would be “prudent” to reduce bond buying, while San Francisco Fed President John Williams said June 3 that a “modest adjustment downward” is possible as soon as this summer.

“With the evaporation of excess liquidity being provided by the Fed, there’s likely to be a greater cost to be extracted by investors on corporate borrowers,” said Robert Smith, the chief investment officer at Austin, Texas-based Sage Advisory Services Ltd., which oversees about $10.8 billion. “I’m afraid of everyone rushing for the door at the same time on the basis of two or three policy statements.”

Smith said it’s unclear if the economy will grow fast enough to warrant a reduction in near-term monetary stimulus.

Employment increased more than forecast in May and the jobless rate climbed from a four-year low as more Americans entered the labor force, showing the world’s largest economy weathered the effects of higher taxes and federal budget cuts.

Payrolls Report

Payrolls rose 175,000 last month after a revised 149,000 increase in April that was smaller than first estimated, Labor Department figures showed today in Washington. The median forecast in a Bloomberg survey called for a 163,000 gain. The unemployment rate rose to 7.6 percent from 7.5 percent.

Investment-grade notes have lost 2.11 percent in the past month, leading to a 0.6 percent decline since year-end on the Bloomberg U.S. Corporate Bond Index.

A month after billionaire Warren Buffett said he felt sorry for fixed-income investors with yields so low, bond prices have tumbled to an average 108.2 cents as of June 5 from as high as 112 cents on the dollar on May 2, according to the Bank of America Merrill Lynch U.S. Corporate & High Yield index.

The $1 billion of 4.5 percent notes due February 2043 from Buffett’s Berkshire Hathaway Inc. have fallen to 98.4 cents, the lowest level since they were issued on Jan. 29, from a record 105.98 cents on the dollar on May 1, Trace data show.

Long-term corporate debt trading at a discount now accounts for about 15 percent of the $970 billion of such securities tracked by Bloomberg. On May 1, notes costing less than 100 cents on the dollar accounted for only 3 percent of the total, which then had a market value of more than $1 trillion.

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