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Fault lines in credit

In writing off all but tag ends of its Nokia acquisition of little more than a year ago, Microsoft produced a $7.5 billion demonstration of the evanescence of modern business value. Creative destruction may be salutary—it *is* salutary. Still and all, destruction costs money.

Credit—the promise to pay money—is the subject of this unfolding narrative. Junk bonds are in the foreground, money is in the background. No further need to reach for a certain kind of yield, we are about to contend; higher speculative-grade yields are coming to you. In advance, we are prepared to assign a cause to the downturn that hasn't fully materialized yet. Six carefree years of Fed-engineered zero-percent funding costs will prove the fundamental reason for the next gust of defaults. The prospective rise in the federal funds rate will turn out to be a causative footnote.

The credit cycle is a mass migration of the mind. It begins with the collective fear of losing money, point A. It ends with the collective fear of not making money, point B.

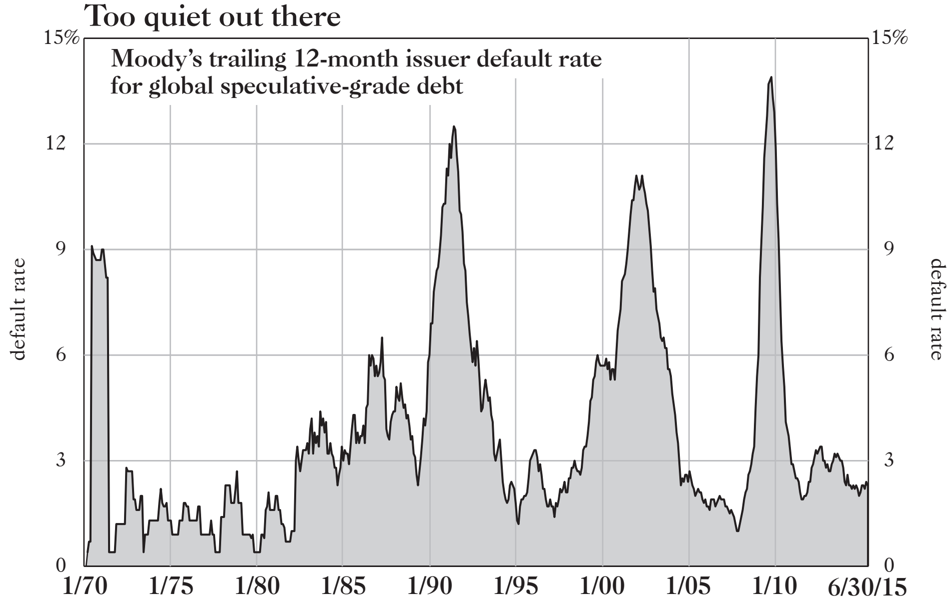
Point A finds lenders and borrowers nursing the wounds of the bust that followed the boom. The penitents resolve to be more careful if only the market will give them another chance. They do not disavow leverage—it is, after all, the raison d'etre of speculative-grade finance. They rather pledge to employ it more prudently. They will henceforth lend at rates that are sensibly aligned with the evident risks of the corresponding borrower. No more updating their Facebook status when they ought to be reading prospectuses, either.

The passing years leach away memories of the bust. Bankruptcy filings become rarities as prosperity spreads its blessings. The return of the itch to speculate means that, for the professional investor, generating gains takes precedence over avoiding losses. Leverage creeps (at length, it gallops) back into the market, and pricing comes to favor the seekers of funds, rather than the providers of funds. Point B is the apex of optimism.

Point A of the present cycle we may pinpoint as March 2009, the nadir of stocks and credit. Point B, we shall guess, has just passed. The crystallization of boom-time optimism occurred on July 16. The oversubscribed sale of more than $1 billion of debt by the Ba-1-rated City of Chicago was the red letter event. A two-line quotation in the *Chicago Tribune* before the sale took place could speak for broad swaths of American speculative-grade finance. "It sounds like we don't have much of a choice," said Alderman Nicholas Sposato, concerning the feasibility of the then prospective issuance. "This is a way to at least put our finger in the hole in the dike for now." The fingers in the dike, duly inserted, belong to America's fiduciaries.

For many a moon, the prices of junk bonds failed to register bad news. That has begun to change. Thus, the Bon-Ton Stores 8s of June 2021, issued at par in May 2013, were quoted at 84 as recently as mid-May of this year; they change hands today at 75, a price to yield 14%. "One might reasonably argue that the prospects for U.S. consumer spending should be pretty

Too quiet out there



source: Moody's

good, given rising employment, growing wages and falling energy prices," colleague David Peligal observes. "The Bon-Ton clientele is not high end, so its demographic should benefit more on the margin. The fact that the bonds are sinking is perhaps telling you something about changing perceptions of credit risk."

A July 30 report on the junk market by Michael Contopoulos et al. at Bank of America/Merrill Lynch makes a persuasive case that, if the top in the junk market is not in, it is likely not far off. "The future is what it used to be" is the promising title. Plainly, the authors—who include Neha Khoda and Rachna Ramachandran—are alert to the cyclical facts of life.

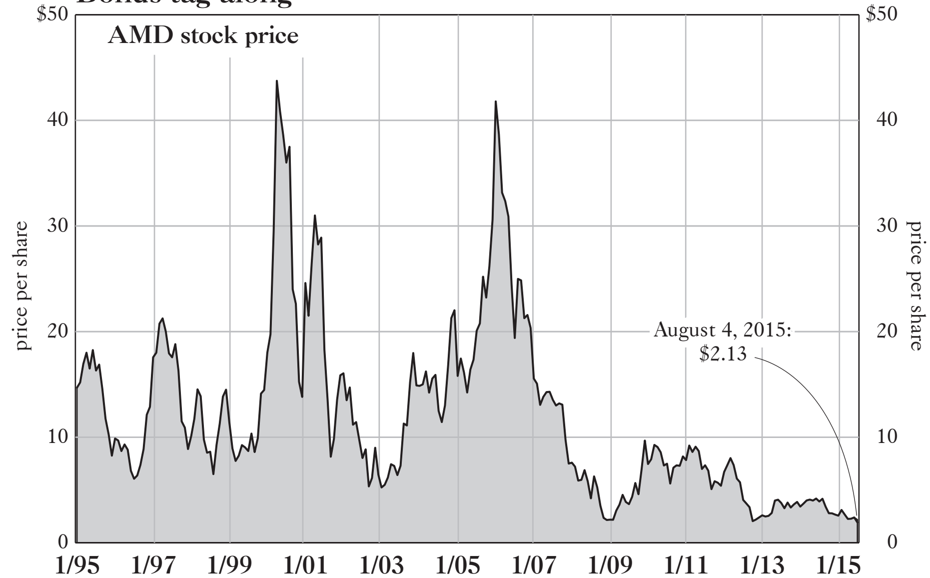
Reversion to the mean is the foremost cyclical fact. Trees don't grow to the sky; the cure for high prices is high prices, and the cure for low prices is low prices. The junk market, though it has suffered a rocky couple of weeks—thereby trimming returns in the year to date to little more than 1%—has by no means corrected the manifold excesses that are so much in need of correcting, the authors assert. Not only is the market not out of the woods, Contopoulos et al. insist, it is "not even in the woods yet."

Well, the market is in the woods of debt. Over the past several years, speculative-grade companies have re-leveraged, "somewhat of an anomaly during periods of decent growth, low default rates and strong equity markets," the report observes. The authors relate that they have looked at leverage in its many different facets: "We have run the numbers using unadjusted EBITDA, adjusted EBITDA including and excluding energy, metals and mining, and materials. . . ." The conclusion is the same, no matter how the data are sliced, they find: "[C]ompanies have re-levered to an extent not seen since the late 1990s."

Apocalyptic, the BofA/Merrill team is not, bearish it is: "In our view, commodity, rate, liquidity and, most importantly, fundamental pressures have yet to fully affect the market, and when they do, we expect further price loss across a broader set of companies."

Naturally, all cycles are different. Radical monetary experimentation is the standout characteristic of this one. Zero-percent funding costs have pulled forward consumption and pushed back distress. They have reduced the returns to skepticism, securities analysis and due diligence. They have prolonged the commercial lives of marginal businesses that, were they forced to finance themselves at normal interest rates, might be pushing up daisies in some reorganization proceeding.

Bonds tag along



source: The Bloomberg

At the spring 2014 *Grant's* Conference, Martin Fridson, now chief investment officer at Lehmann Livian Fridson Advisors, imagined the next wave of speculative-grade defaults. It would begin in 2016, he projected—that is, it would likely begin in 2016 if past were prologue. The wrinkle was that, in this day of monetary activism, the past may not be prologue. Thus, in 2009, 13.3% of the speculative-grade issuer universe defaulted. It was far and away a record for any year in the 45 years since the data were first collected. Yet—remarkably—in 2010 the default rate subsided to 3.3%, slightly below the long-term average of 4.6%. "I would submit that is physically impossible," said Fridson, still amazed at this occurrence a half-decade after it happened. "But it did actually happen, and I think that the only conceivable explanation is the Fed's extraordinary intervention."

Contopoulos et al. compare 2015 to 1998, a year best remembered, if at all, for the flameout of Long-Term Capital Management. The year 1998, like 2015, saw plunging oil prices, swings in quarterly GDP readings of as much as four percentage points, apprehension over a Fed tightening cycle and flattish junk-bond returns. Front and center, too, was the concentrated issuance of speculative-grade debt in a certain favored industry. The fair-haired segment of 1998 was telecommunications, that of the present is, or rather was, commodities. "High yield typically overbuilds in one industry before realizing stress in that sector," the BAML report observes.

We would amend that statement. Credit markets tend broadly to overbuild. They tend especially to overbuild when tempted by governmentally suppressed interest rates. Junk bond yields beginning with the number "five" and sovereign debt yields beginning with the number "one-half of one" have proven temptations impossible to resist.

Intimations of trouble in telecom did not, at first, trouble the broad junk market. Investors wrote it off as a speculative outlier. Only gradually did they lose faith in industries and companies that they had previously assumed to be safe. Skepticism proved contagious once it set in. "It is this heightened skepticism that ultimately feeds into capital markets, creating a re-pricing of risk and ultimately a lack of desire to fund risky companies," the authors say, and they add: "We're seeing similar behavior today. A year ago, weakness was isolated to metals and mining and pockets of retail. This 'idiosyncratic' weakness bled into energy in the fall, and now is beginning to affect wireline, technology and financial companies."

Advanced Micro Devices is an example of a speculative-grade issuer to which the market has belatedly given the fish-eye. Incorporated in 1969 and public since 1972, AMD is a Silicon Valley senior citizen. It designs and markets semiconductors for use in personal computers. As recently as 2012, the company's PC-centered business designated "computing and graphics" generated revenue of $4.7 billion and operating income of $129 million. That was as good as it got. In the first six months of 2015, AMD logged revenue of just $911 million and operating income of minus $222 million.

A second AMD division, the "enterprise, embedded and semi-custom" unit, is both profitable and growing, though it is not so profitable, nor so fast growing as to lift the corporate whole. Companywide revenue and earnings per share both peaked in 2011. EPS turned negative in 2012 and has not returned to the black. Second-quarter 2015 results featured dwindling sales, declining cash and rising inventories. Revenue declined by 35% vs. the previous 12 months, a plunge that included a 54% drop-off in the legacy PC segment. Not only is PC demand falling, but AMD is also taking a smaller share of what remains. "So it's quite possible," Peligal points out, "that AMD only generates total 2015 revenue of slightly more than $4 billion. If true, it would be down by a little more than 25% from 2014. The closest debt maturity is March 2019, which, at this rate, may be closer than it seems."

It falls to management to keep up a brave face—if not management, who?—and AMD's chief financial officer, Devinder Kumar, tried to put the minds of dialers-in at ease on the second-quarter conference call. "As far as the financing is concerned. . . ," he said, "I monitor the capital markets pretty closely and if the need arises, obviously, we'll access the capital market. . . . If you think about it, with the cash that we have, we also have ABL [asset-backed revolving credit accommodation] availability that we put in place in the late part of 2013 and that's not all fully tapped out."

In his expressed optimism concerning the hospitality of the credit markets, Kumar recalled the words of Chicago's Alderman Sposato. Willing fingers plugging leaky dikes is all very well in the bullish portion of the credit cycle. The gentlemen will find that the fingers are hard to come by in the bearish portion. It seems to us—to repeat—that we're in it.

It's no news at all that the PC business is in long-term decline. What is new is the bond market's recognition of that fact. The stock market has long been fully briefed. AMD common is heavily shorted and hugely expensive to borrow (a trader we know was offered 25,000 shares at a cost of 16 ½% of the share price per annum). It trades at around $2 a piece, lurching higher in response to periodic recalls of borrowed shares. Altogether, some 24% of the company's 633 million-share float is sold short. On July 28, Moody's slashed the rating on four issues of senior unsecured AMD notes to Caa2 from Caa1, the new rating being four notches from C, which means *finis*. "As a result of projected operating losses," said the agency, "credit metrics will be very weak, with negative EBITDA relative to $2.5 billion of adjusted debt, and negative free cash flow."

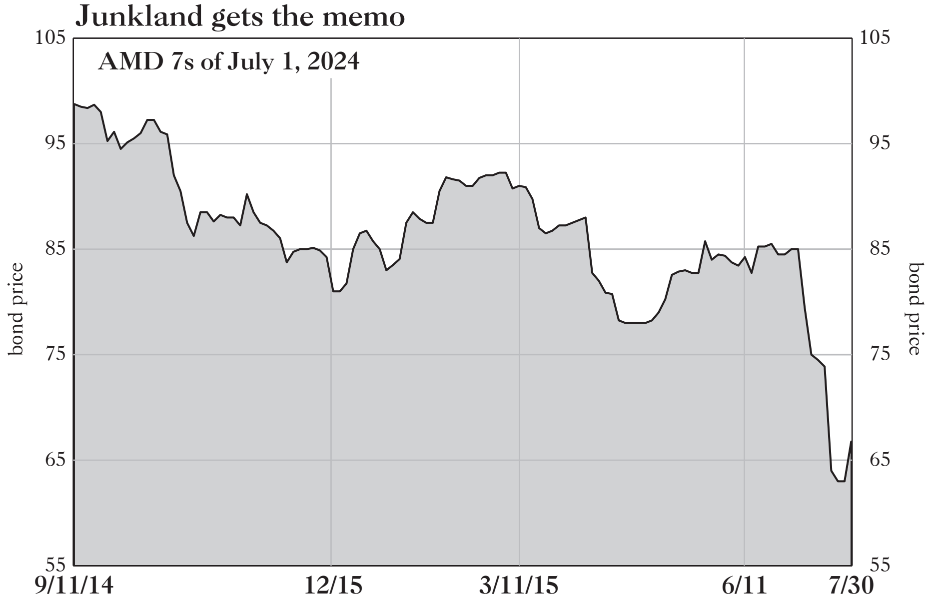
The senior unsecured AMD 7s of 2024, which had changed hands at 85, a price to yield 9.5%, as recently as July 2, are quoted at 68 today, a price to yield 13%. The problems that have lately come to light were not previously in the dark—certainly, not when the 7s came to market in June 2014. As those securities flew out the window and into the hands of yield-famished investors at 100 cents on the dollar, the AMD share price was quoted at just $4. Here was a broad hint that something was wrong. Whatever the bull case on the stock might have been—something to do with intellectual property assets? With a hoped-for upturn in the PC market? A potential takeover—the bull case on the bonds was as modest as the bull case for a corporate debt security has ever been. To wit: "If all goes well, you'll recover your principal at maturity while earning the coupon in the interim. The upside is par. The downside is default with uncertain recovery."

At least, that was the pre-ZIRP value proposition. Radical monetary policy transformed the arithmetic. A 7% yield to a 10-year maturity is a king's ransom compared to the Treasury's 2%-and-something 10-year paper. Then, too, the argument goes—or went—the Fed would lift the funds rate most deliberately, if at all.

Creditors have reached for yield as long as there have been yields to reach for. The reaching has been more acrobatic this time around because the need has been greater. The need must explain Chicago's otherwise inexplicable success last month in placing $743 million of 7.55% taxable general obligation bonds due 2042 and $346 million of 5.5% general obligation tax-exempt bonds due 2039. The creditworthiness of the issuer in no way accounts for it.

Our friend Michael Lewitt, proprietor of the monthly *Credit Strategist*, points out that a July 24 court decision

Junkland gets the memo



source: The Bloomberg

by the Cook County Circuit Court scuttles plans of Mayor Rahm Emanuel to restructure the city's pension funds in such a way as to postpone their inevitable insolvency. If, as the court held, benefits once promised but now unpayable cannot be renegotiated, bondholders may be out in the cold. "The negative outlook," said Moody's in May when downgrading America's third-largest city to junk, "also reflects our expectation that Chicago's credit quality will weaken as unfunded liabilities of the municipal, laborer, police and fire pension plans grow and exert increased pressure on the city's operating budget."

Lewitt: "Why any responsible manager would think that an 8% taxable yield on a 27-year bond or a 5.7% tax-exempt yield on a 24-year bond is sufficient compensation for the risk of owning Chicago's debt is a total mystery, particularly in view of the recent experience of those who rushed to buy Puerto Rico's 8% Series A general obligation bonds due 2035 in March 2014. Those bonds are guaranteed tickets to the boneyard."

Something is changing, as the BAML analysts observe. Caa spreads widened in the first four months of the year, even as the broad junk market rallied. Not that such cracks have yet defaced much of the surface area of the speculative-grade market—"as recently as a week ago, the ex-commodity portion of high yield was still yielding less than 6%." Team BAML adds that the evident complacency is no bullish sign but a worrying one, "just a delay of the inevitable and an indication that there is room to move lower in price." They point a finger of blame to where, in this publication's estimate, it ought to be pointed: "By inducing reach-for-yield behavior, the Fed may have incentivized the market to overlook fundamentals, creating sensitivity to those metrics when macro liquidity begins to dry up. Given the near doubling in the size of the market since 2008, we think crowded trades are likely to unwind, meaning both high yield as an asset class as well as crowded sectors."

As the market has grown larger, failure has become rarer. Over the past 12 months, according to Moody's, just 2.3% of the market, measured as a percent of all speculative-grade issuers, has defaulted, one of the lowest rates since the start of record keeping in 1970. The narrative just presented would suggest that the default rate is headed much higher—that if it were a stock, you would want to own it.

Invited to freshen up his forecast that the next default cycle is right around the corner, Fridson replies that he stands by it. Next year—some time next year—he expects "a multi-year period in which the default rate is at or above the long-term average of 4.6%" to get underway.

"I still think it is possible," Fridson tells *Grant's*. "The market right now is saying—by my interpretation—that the default rate will run about 3% over the next 12 months. That gets you into the first half of 2016. . . . The Fed may be able to stave that off through continuing Herculean efforts, but then again, maybe not. With everything they are doing, maybe we will still see some natural, cyclical economic forces play out."

It happened in Vietnam last year, according to a July 20 dispatch in *The New York Times*, when, in the wake of a debt crisis, 78% of registered companies in Ho Chi Minh City went broke. "But the creation of new companies has since gathered pace," the paper said; "so far, 26% more new companies have been formed this year than in the same period last year."

"'Weak companies will fail; that's normal,' said Tran Anh Tuan, the acting president of the Ho Chi Minh City Institute for Development Studies, a government planning agency. 'They can learn from failure. That's a good way to develop.'"

Over to you, Janet Yellen.

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