

Bond Boom's Thin Ice

Corporate Debt, and Investors Who Bet on It, Face End of Easy Money

By SERENA NG

February 6, 2007; Page C1



It is the biggest worry in the corporate bond market these days: What comes down must go up.

The interest rates corporate borrowers pay on their debt have fallen in the past few months. Not only is inflation tame -- which helps hold rates down -- but corporate defaults have sunk, making lenders willing to take more chances with their money for less return.

- The Situation: Corporate bond yields are near to historic lows.
- What's Behind It: Companies are borrowing cheap, because defaults are low and investors are eager to lend.
- What's Next: Credit cycles usually last five to seven years, meaning rates could head back up, hurting investors and borrowers.

With so many investors flush with cash, they have been throwing it at corporate bonds, pushing their prices up and their yields down. As a result, even the shakiest corporate borrowers aren't paying a lot more than the government pays for a loan.

Now, some analysts and investors are warning the cycle will eventually run its course, meaning higher corporate borrowing rates, which could affect the ability of some companies to thrive, and a hit for investors betting on corporate debt.

"It's like there's no fear of the downside," said Jeffrey Rosenberg, head of credit strategy research at Banc of America Securities in New York.

Some money managers are taking a more cautious stance. Thomas Atteberry, a fixed-income manager at First Pacific Advisors LLC in Los Angeles, has reduced his portfolio's allocation to corporate bonds rated A or lower to 3% from around 25% in early 2003.

"We're not taking the credit risk because we don't think we are being compensated enough for it," he said.

The bond boom has been a blessing for companies like fiber-optic network operator Level 3 Communications Inc. In October, its financing unit issued \$600 million in bonds with an interest rate of 9.25%. That was much lower than the 12.25% rate it agreed to pay on \$250 million in bonds just seven months earlier, according to data from Standard & Poor's Leveraged Commentary and Data group. For every \$100 million it borrowed, its interest costs effectively fell by almost \$3 million a year.

Level 3 bonds are rated CCC-minus by S&P, meaning they are below investment grade -- or junk -- and the ratings service sees the company as among the most likely to default. Other companies, like Sbarro

Inc. or Pilgrim's Pride Corp., have been able to borrow at similar rates. Buyout funds also have been seizing on these low corporate borrowing rates to raise money for takeovers.

In late January, junk-bond yields fell to a 10-year low of 2.57 percentage points above Treasury yields, according to a Merrill Lynch index.

That was down from 3.71 percentage points above Treasury securities at the end of 2005 and more than 10 percentage points above Treasuries in the fall of 2002, when the economy was shakier and the market less-forgiving.

Bond investors call the difference between a corporate bond's yield and a Treasury bond yield "the spread." When the spread is so narrow, it means investors see little risk in owning corporate debt.

Treasuries tend to pay lower rates than corporate bonds because the government is so unlikely to default. As spreads have gotten narrower, corporate bonds have been rewarding investors. Even though the interest rates on these bonds are relatively low, the prices of the bonds have been going up because of declining defaults.

Now, many investors are beginning to worry that with spreads so low, they surely will rise. As of yesterday, the spread on junk bonds had widened a bit to 2.67 percentage points over Treasuries.

"We're...happy about the gains but we're squirming in our seats and worrying that the shoe will drop," said Peter Andersen, a bond portfolio manager at Dreman Value Management LLC in Jersey City, N.J. "We're worried about any misstep a company may make and how the market will react to it."

Defaults on U.S. junk bonds last year totaled about 1.3% of all junk bonds outstanding, well below the historical average of 4.5%, according to S&P. But just like the economy, the credit market goes through cycles, with periods of low defaults and periods of high defaults and widespread losses. The latest stretch of falling default rates has lasted for more than five years. Past cycles have turned within five to seven years.

The last time bond spreads were close to current levels was in the fall of 1997. A string of events that followed, including the Asian currency crisis and the implosion of hedge fund Long-Term Capital Management, shook investor confidence and caused bond prices to fall, pushing their yields higher and widening spreads against Treasury securities.

The early 2000s saw the collapse of many telecommunications companies, which had borrowed heavily but later failed to meet their revenue targets and cover their interest payments, triggering a surge in defaults.

Some analysts believe the credit cycle may be more prolonged this time. The financial system is flush with banks and investors willing to lend, allowing even weak firms to raise money they need to keep operating.

The investor base for corporate debt also has expanded, with hedge funds and foreign investors channeling record sums to the sector. Foreigners are the biggest owners of U.S. corporate bonds, with a 29% share, according to research firm CreditSights Ltd., which analyzed data from the Federal Reserve.

Meanwhile, credit derivatives are allowing more investors to participate in the market and to hedge their risks.

"I definitely believe it's different this time, but that's not to say that the bond market won't have a day of reckoning," said Louise Purtle, an analyst at research firm CreditSights Ltd.

For now, money managers are on the lookout for any event that could derail the outlook for companies and cause defaults to pick up. A sharp fall in oil prices, a sudden decline in the U.S. dollar, or a fallout from problems in the subprime-mortgage industry are among the potential threats.

"We're all looking over our shoulders for the boogeyman," said Raymond Kennedy, a high-yield portfolio manager at Pacific Investment Management Co., or Pimco.

CME Is Allowed to List Some Default Options

The Chicago Mercantile Exchange won regulatory approval to tap into the booming credit-derivatives market, despite protests from a rival exchange.

The Commodity Futures Trading Commission granted permission last week for the CME to list contracts for investors seeking to hedge the risk of bankruptcy for three companies near or below the line that divides investment-grade from speculative rankings. The companies are Centex Corp., Tribune Co. and Jones Apparel Group Inc.

CME, a unit of Chicago Mercantile Exchange Holdings Inc., had reduced the scope of its proposal to include just bankruptcies, rather than other credit events such as defaults, failure to pay, or restructuring.

The Chicago Board Options Exchange had argued that the CME's proposal was more closely aligned with securities and wasn't a futures contract. As a result, the options exchange said approval to list the contracts was needed from the Securities and Exchange Commission.

The options exchange is seeking SEC approval to list credit-default options similar to the CME's product. Exchange representatives weren't immediately available yesterday to comment on the CFTC ruling.

-- Howard Packowitz

Treasurys Increase; Yield at 4.808%

Treasurys rose yesterday as investors chose to focus on weaker data released in the prior week and ignored stronger-than-expected service-sector data reported in the morning.

Treasurys remained largely indifferent to the Institute for Supply Management's higher reading for January of the U.S. nonmanufacturing sector. The ISM survey showed a rise in nonmanufacturing activity, to 59 compared with December's reading of 56.7. Economists surveyed by Dow Jones Newswires had expected a figure of 57 for last month. The January figure was the best since May.

"I think it's just everybody digesting the fact that the data last week was slightly weaker in terms of the economy, so there's been a little follow-through from last week," said Raymond Remy, head of fixed-income for Daiwa Securities America in New York.

The benchmark 10-year Treasury note was up 5/32 point, or \$1.5625 per \$1,000 face value, at 98 19/32. Its yield fell to 4.808% from 4.828% Friday, as yields move inversely to prices. The 30-year bond was up 7/32 point at 99 22/32 to yield 4.911%, down from 4.927%.

--Danielle Reed

Lear Bonds Decline

Lear Corp. bonds fell after the auto supplier announced that financier Carl Icahn has offered to acquire the company for \$36 per share in cash.

Lear's 8.75% bonds due 2016 slipped 1.375 point, or cent on the dollar, to 98.75 in heavy trade, according to MarketAxess.

Its 8.5% bonds due 2013 dropped 1.75 point to 99 points.

-- Michael Aneiro

Write to Serena Ng at serena.ng@wsj.com

Copyright 2007 Dow Jones & Company, Inc. All Rights Reserved This copy is for your personal, non-commercial use only.

Questions

- 1) What has contributed to the recent drop in corporate bond rates?
- 2) Explain the relationship between bond prices and bond yields. When interest rates drop what happens

to bond prices? To bond yields?

3) What is referred to as "the spread"? Why do Treasury securities tend to pay lower interest rates than corporate bonds? How have corporate bonds been "rewarding" investors lately?

4) How has the spread between Treasury securities and junk-bond yields changed since 2002? What does this suggest about investors risk expectations on corporate debt?

5) What has been the historical average default rate on U.S. junk bonds? What was it last year? Is this expected to continue?

6) Why do some analysts think the credit cycle may be more prolonged this time? What are the potential threats that could "derail" this outlook?

7) Define the terms "coupon rate" and "effective interest rate" as they relate to corporate bonds.

8) How is the price of a bond related to its effective interest rate?

9) Describe the current conditions in markets for corporate bonds. Comment on both investment grade bonds and junk bonds, including definitions of these two groups of bonds.

10) What factors may cause the current conditions in corporate bond markets to change? List all that you can glean from the article. Include in your discussion a definition of "bond default" and their impact on bond markets.

11) If the current market conditions for corporate bonds change, how will that change impact companies planning to issue bonds in the near future?

12) How might the impact described above further affect the bond market itself leading to the "credit cycle" described in the article?
