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# THE CORPORATE DEBT VIRUS

Arturo Schembri
President, Minerva IMS

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## THE MARKET

Since the very first days of 2020, the global medias' front page has been about the SARS-Cov-19 and its related disease, the Covid-19. More than 89,000 cases in few months and about 3,000 deaths. Governments stopped flights, issued emergency measures, closed frontiers. And the stock markets went down.

Stock prices went down as fast as the fear of a new global threat soared. In the last 10 trading days the NYSE, FTSE MIB, HKEX, and many other stock exchanges closed almost every day with a negative sign behind the price level. Conversely, the benchmark 10-year Treasury yield blasted through its four-year-old record of 1.32 percent last week, setting a low of 0.96 percent by 12 A.M. on Thursday, 5th of March. High demand for US-Government Bond is a good sign that fear is spreading among investors.

There is an open debate among economists and professionals on whether the impact of the virus can be bigger than expected. Co-ordinated actions by central banks and governments are becoming more likely. Assuming that happens, and helps to spread calm, then in time it should stem demand for "safe assets" such as government bonds and gold. But this is not happening right now.

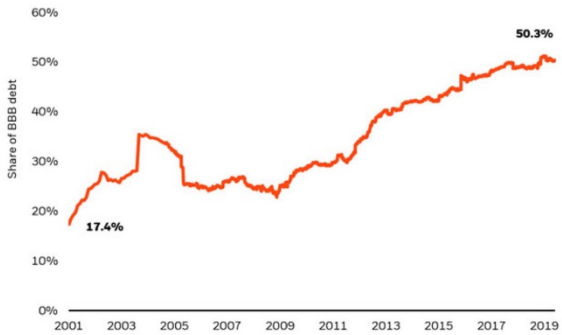
## THE CORPORATE DEBT VIRUS

What has been happening through years, instead, is the soaring of the debt market capitalization – both household and corporate debt.

Aggregate household debt balances increased by $193 billion in the fourth quarter of 2019 – a 1.4% increase q/q – now stand at $14.15 trillion. Balances have been steadily rising for five years and in aggregate are now $1.5 trillion higher, in nominal terms, than the previous peak (2008Q3) of $12.68 trillion.

Global corporate debt market capitalization has reached $10 trillion dollars in 2019. Just in the U.S., the corporate debt as a percentage of GDP is at 47%, the highest level since 2009. But the interesting data is about the BBB-rated corporate bonds: they account for over 50% of the market, versus a 17% back in 2001, as showed in the graph.

**BBB-rated bonds represent over 50% of investment grade debt**
BBB share of global investment grade corporate market



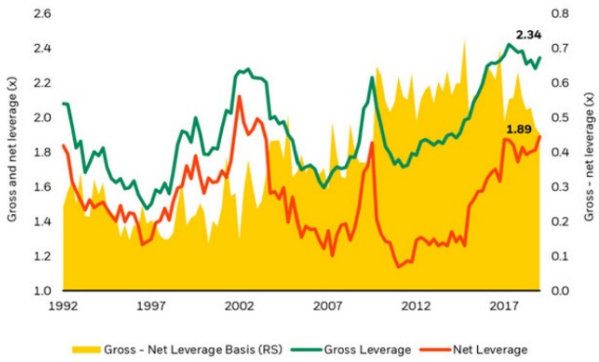

Source: Bloomberg Barclays, as 6/28/2019.

There is a main reason behind this: the decade-long period of ultra-low interest rates. It has also been the main backdrop in this period of growth.

Historically, low global interest rates encouraged companies to use more debt to fund business operations, refinance existing obligations, conduct M&A activity, and/or expand dividend or share buyback programs. This burgeoning global supply of corporate debt has been met by strong demand by yield-starved investors.

The same investors cannot be satisfied with low-interest-rates-paying government bonds. They seek for high-yield-paying bonds, despite accepting a higher risk.

**Investment-grade leverage levels are higher than historical norms**
Leverage of global investment grade corporate bonds




Source: Morgan Stanley, Bloomberg, as at 3/31/2019.

In the chart above, gross leverage is calculated as total debt/12-month EBITDA. Net leverage is

calculated as (total debt less cash and cash equivalents)/12-month EBITDA. A shrinking basis between gross – net leverage is usually a sign that investment-grade balance sheets are holding less cash. Higher measures of leverage typically indicate greater issuer risk.

Thus, the BBB-rated bonds have reached an outstanding level in the recent years. Investors hold nearly $4 trillion in these bonds, including $2.5 trillion from U.S. companies, according to the credit rating agency Standard & Poor's.

## REFINANCING THE ECONOMY

With an economy heavily based on debt, the systemic risk is increasingly important and economic contingencies play a key role.

The ageing business-cycle, the repeated central banks attempts to keep the horse run for a little while longer, the systematic uncertainty that characterizes these days. Plus, a new global threat that can play the straw that breaks the camel's back.

The Covid-19 impact has surely affected the 2020's 1st quarter. Can it have an impact also on the rest of the year? It depends on the economic reaction when companies will try to refinance their huge debt in the incoming months. There is now a real risk of a severe tightening of credit in leading economies, spurring a rising default rate among companies.

The primary concern is likely to be the debt rollover in the next three to six months, since the firms are being hit by the revenue shortfall caused by the generalized panic that embraces the SARS-Cov-19.

If the companies will not roll their outstanding debt, a ripple effect can dramatically increase the rate of default of such debt, and the securitized products attached. Yes, because there are still plenty of collateralized products, no longer based on mortgages and household debt but on corporate one. However, this is another topic to be discussed.

Most importantly, the downgrading that will spur from the inability of corporates to repay debt – or just roll over it – can lead to a more insecure economic structure that, in the case of a new recession, will break its legs like breadsticks.

An analysis by Morgan Stanley found that significant volumes of BBB-rated bonds were downgraded in previous credit downturns. In the 2007-09, 2000-03 and 1989-91 downturns, between 23% and 45% of investment-grade bonds were downgraded to junk. If downgrade rates were to remain at such levels, the next downturn could see approximately $600 billion of BBB bonds consigned to junk status.

## NEXT

Hopefully, the new SARS-Cov-19 will stop bleeding in the next weeks. Governments are facing not easy times, but they are managing to contain the social impact. Rumours about central banks' reactions are the order of the day. A new wave of monetary stimulus accompanied with a rate cut is the most blazoned policy according to social medias and economists' opinions.

However, investors and policy makers must wait until the end of May to assess any rebound and the effect on profit margin and growth of the private sector. Only then, the data covering April can give us the chance to understand the real economic impact of the corporate debt virus, and, if any, to discover the cure.