Who Are The Next Auto Wrecks?

"Give me a place to stand and a lever long enough and I will move the world"… Archimedes

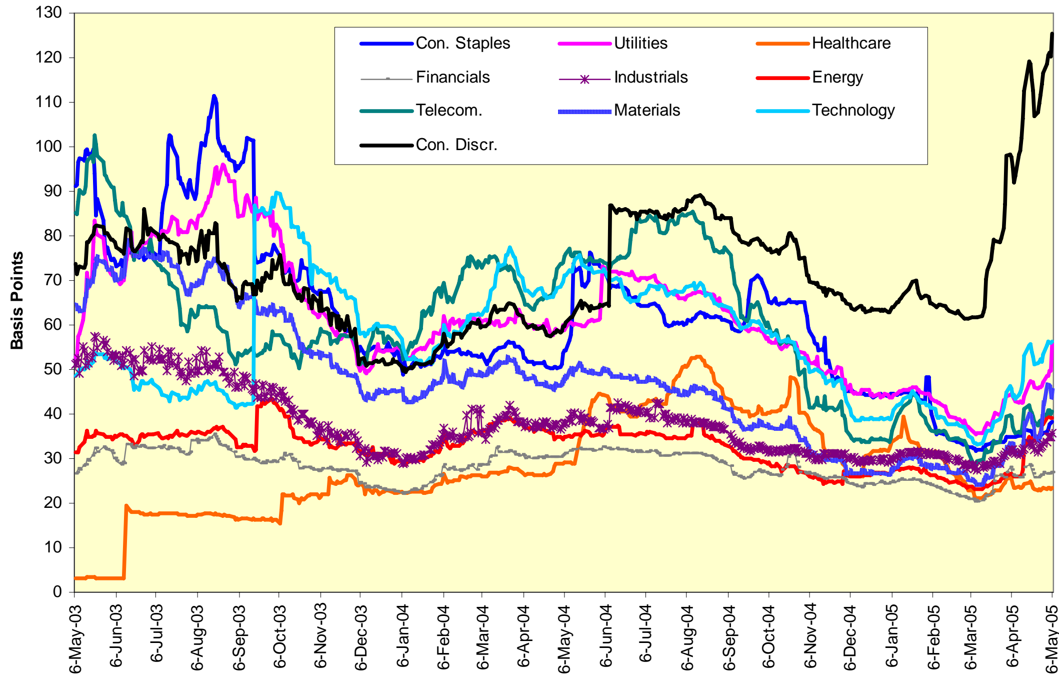
History is silent on Archimedes' understanding of financial leverage, but it might be a fair bet anyone who could describe such diverse problems as leverage and buoyancy would grasp the concept easily. Whether he could extrapolate the shipping-based economy of his home town of Syracuse to the modern credit-based economy, one wherein automobiles are manufactured as an excuse to make automobile loans, is more of a stretch: Like all ancients, he probably was a "show me the money" sort.

On the subject of buoyancy, stocks float on a sea of bonds. As discussed here last month, the relationship between corporate bonds and stocks is highly asymmetric. A stock can get hammered on all manner of silliness without affecting the bond, but if a corporation's bonds are in trouble, the stock will get dragged lower until and unless a suitor for the stock emerges. Last Wednesday's pot-clanging bid by Kirk Kerkorian for General Motors was just the sort of event that could rescue a weak stock from the issuer's weaker bonds, as is any leveraged buyout situation.

Credit Risk By Sector

Standard & Poor's divides the market into ten economic sectors. As is the case in all such taxonomy schemes, definitions can get a little arbitrary. The embattled automobile industry, for example, is included in the Consumer Discretionary sector and not in the industrial sector. General Electric, which is as much of a financial firm as a manufacturing one, is in the Industrials and not in the Financials. But at least the classifications are consistent and known to all.

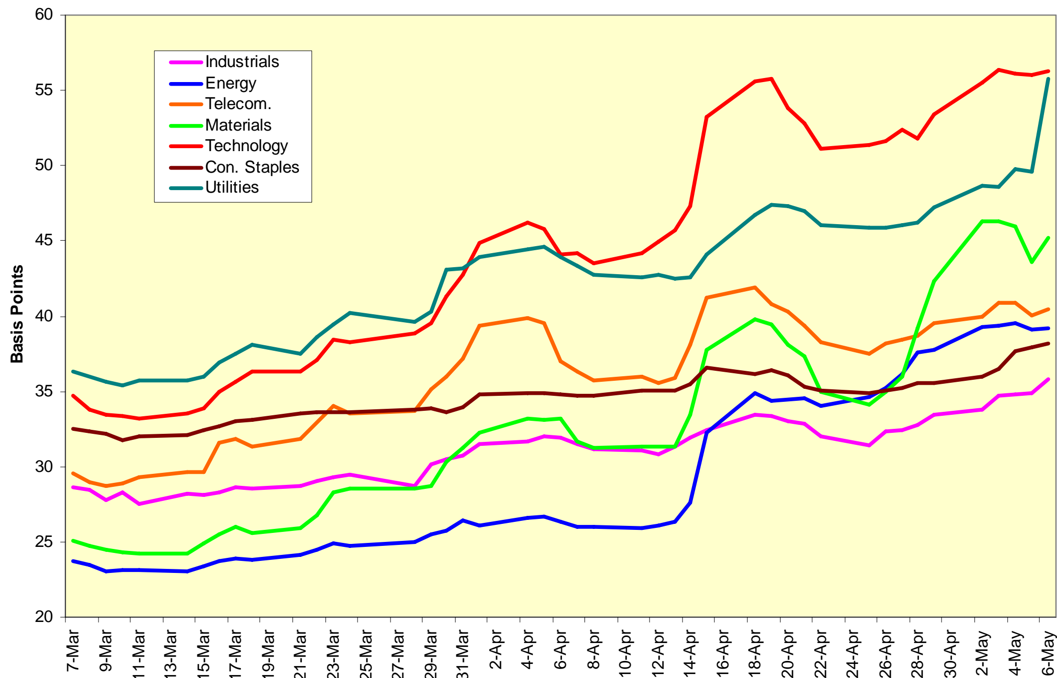
If we take the cost of a five-year credit default swap (CDS) for each member of each economic sector and construct a weighted average for that sector, we can depict each sector's relative credit health. The most striking development in corporate credit is the literally off-the-chart condition of the Consumer Discretionary sector, home not only of the auto industry, but of such stalwarts as Home Depot, Time Warner, Comcast, Viacom, Walt Disney, News Corporation, eBay, Target, Lowe's and McDonald's. The second development is the continued great health of both the Utilities and Consumer Staples sectors. Consumer Staples includes Wal-Mart, Procter & Gamble, Altria, Coca-Cola, Colgate-Palmolive and Anheuser Busch.



Two other sectors, Healthcare and Financials, have been flat-lining in recent weeks. Healthcare has had an interesting history over the past year; the CDS costs of Pfizer and Merck both jumped during their respective COX-2 inhibitor travails, but as both companies are likely to survive in a form other than a plaintiffs' trust, their credit quality has improved. The Financials have been playing the roadrunner unto everyone else's Wile E. Coyote; this is the sector everyone expects to get too smart for its own good, especially as the Federal Reserve continues to raise short-term rates and flatten the yield curve, but the credit markets are satisfied with their performance.

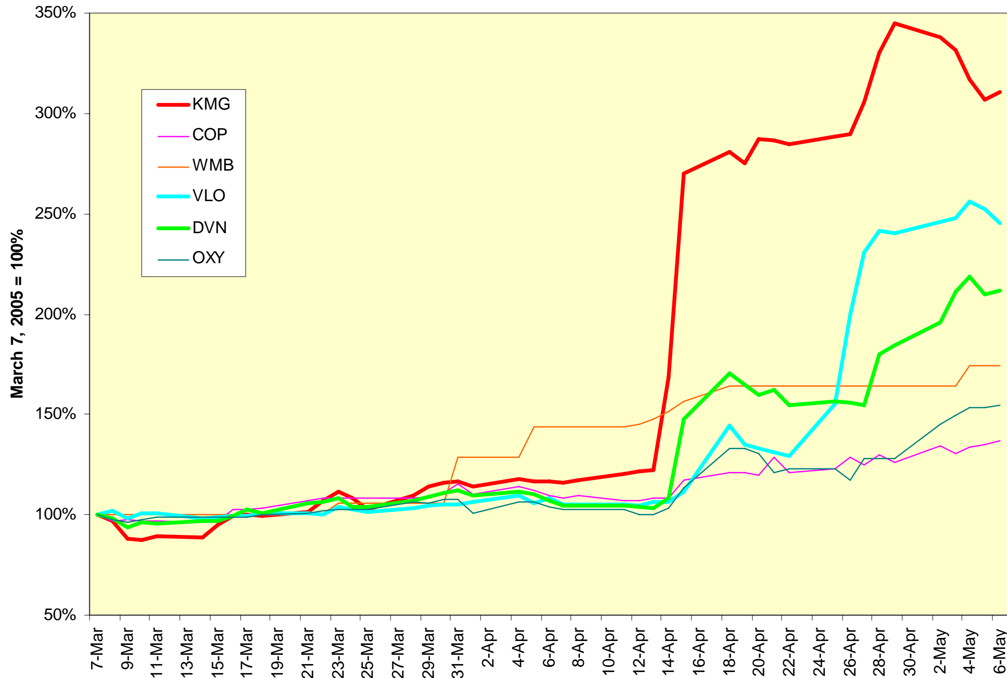
The Middle Tier Risks

What about the remaining sectors, Energy, Materials, Technology, Industrials and Telecommunications? All of them have seen a substantial increase in their CDS costs since early March. The increases have been most pronounced in the Energy and Materials sectors, and the level of CDS costs are now the highest in the Technology sector.

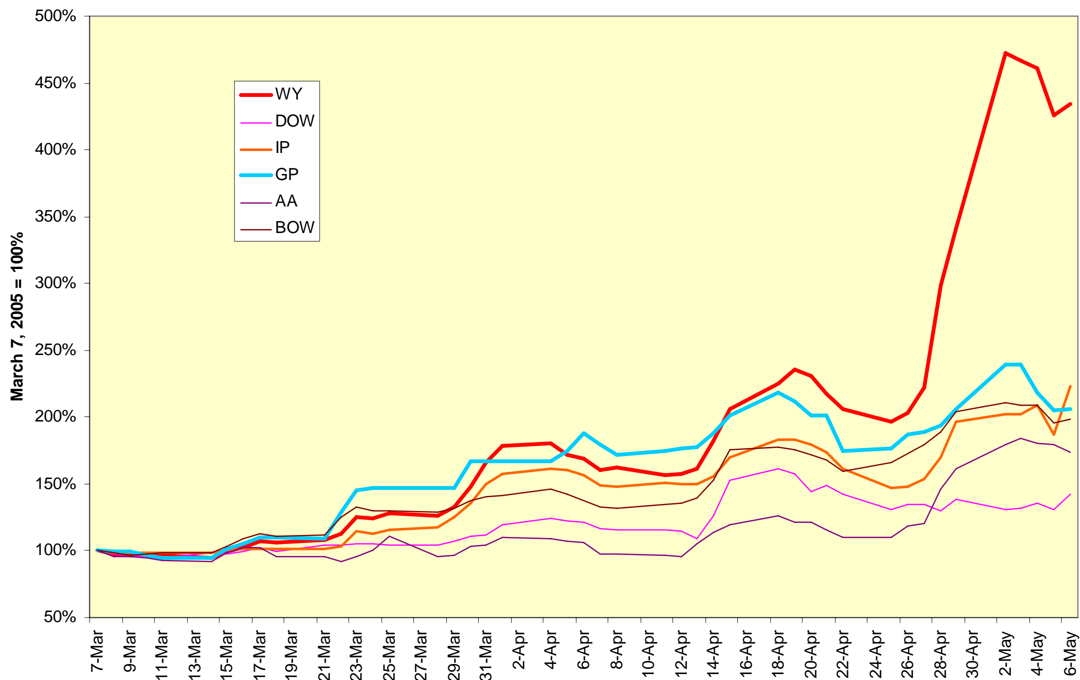


Energy and Materials have been the stars of the market over the past year, with total returns for the sectors of 40% and 22%, respectively. Given the pattern in finance of success breeding excess, are there any members of these two sectors who have taken their leverage to excess as evidenced by their CDS costs?

In the Energy sector, three firms have seen their CDS costs rise sharply since early March. Kerr-McGee saw its costs rise after its April 14th announcement that it would sell $4 billion in assets to buy its own stocks. Valero saw its costs rise after its April 25th announcement it would buy Premcor. And Devon Energy's costs rose on its May 3rd announcement it would retire convertible debentures.



The Materials Sector only has one dramatic increase, that of Weyerhauser. This CDS jump came after Franklin Resources announced on April 29th it had acquired 7.1% of the company and urged the company to make changes to "boost the value of the stock."



A common theme in all three announcements is someone other than the bondholder is being rewarded by management. This is a downside of modern executive compensation: Anyone whose paycheck is linked to the stock price has an incentive to be aggressive on behalf of the shareholders, not the bondholders. If we learned anything from the past decades "Executives On Trial" extravaganzas, it should have been that a compensation level, once achieved, is not abandoned without a fight. Restated, executives who have gotten a taste of mega-riches are going to do anything to maintain those riches at the expense of whomever.

If we are to remain in a difficult market environment and in a difficult management environment - anyone want to sign their name to a Sarbanes-Oxley attestation of the financial statement? - we are likely to see more and more firms go private in one way or another. That is bad news for the bondholders. But as we saw during and after the 1980s leveraged buyout boom, it is often bad news for shareholders as well; few managers know how to run a company for the sole purpose of paying off a note.

The jumps in CDS costs for firms who are going down these paths are a warning of difficulties ahead. Archimedes would have understood: Even though he likely wore a toga-like robe, the concept of lining one's pockets at the expense of others certainly would have been familiar.